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Supreme Court of the United States

October Term, 1939.

No. [redacted] 8

CRANE-JOHNSON COMPANY, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE,

APPENDIX

TO BRIEF *AMICI CURIAE* IN SUPPORT OF PETITION FOR WRIT OF *CERTIORARI*.

HARRY O. GLASSER,
805 Broadway Tower,
Enid, Oklahoma,
ROBERT L. JUDD,
921 Kearns Bldg.,
Salt Lake City, Utah,
W. S. GREATHOUSE,
1824 Exchange Bldg.,
Seattle, Washington,
Amici Curiae.

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EXHIBIT "A."

IN THE DISTRICT COURT OF THE UNITED STATES,
IN AND FOR THE DISTRICT OF UTAH
Central Division

Civil No. 84
COMPLAINT

UTAH HOTEL COMPANY, a Corporation,
Plaintiff,
vs.
IRA N. HINCKLEY, Collector of Internal Revenue, District of Utah, Defendant.

Comes now the plaintiff above named and for cause of action against the defendant alleges:

1. That plaintiff now is, and at all times hereinafter mentioned has been, a corporation organized and existing under and by virtue of the laws of the State of Utah, with its principal place of business at Salt Lake City, Utah.

2. That defendant now is, and at all times hereinafter mentioned has been, the duly appointed, qualified and acting Collector of Internal Revenue in and for the District of Utah, and as such officer of the United States now occupies and executes the duties of said office.

3. That the claim here sued upon arises under the laws of the United States and especially under Sections 14 and 26 of the Federal Revenue Act of 1936, approved June 22, 1936, and also under the Constitution of the United States and the amendments thereto.

4. That on or about March 15, 1937, under the Act of Congress approved June 22, 1936, and known as the Revenue

Act of 1936, the plaintiff filed with defendant its corporation income and excess profits tax return showing taxes as follows:

Excess profits tax	None
Normal income tax	$12,440.15
Surtax on undistributed profits	16,199.99
Total	$28,640.14

5. That said normal tax was paid in installments on the following dates, to-wit:

March 15, 1937	$ 3,110.04
June 15, 1937	3,110.04
September 7, 1937	6,220.07
Total	$12,440.15

which said tax was lawful and no claim was made for any refund.

6. That said surtax on undistributed profits, as defined in Section 14, with credits allowed as provided by Section 26, both in the Revenue Act of 1936, was paid involuntarily and under protest in installments on the following dates, to-wit:

March 15, 1937	$ 4,050.00
June 15, 1937	4,050.00
September 7, 1937	8,099.99
Total	$16,199.99

7. That as a result of an examination of plaintiff's books and records by a Federal Internal Revenue Agent an additional income tax was proposed for assessment for the year 1936 as follows:

Normal income tax	$ 280.21
Surtax on undistributed profits	325.53
Total	$ 605.74

and that such additional tax as proposed by the Federal Revenue Agent was paid under date of July 15, 1938, as follows:

Tax paid which was lawful and for which no claim for refund has been made:

Additional normal income tax	$280.21
Interest from March 15, 1937, to July 15, 1938, at 6% per annum	22.42
Total	$302.63

Amount paid involuntarily and under protest:

Additional surtax on undistributed profits.	$396.58
Interest at 6% per annum from March 15, 1938, to July 15, 1938	7.93
Total	$404.51

8. That claims for refund have been made and filed by plaintiff with the Collector of Internal Revenue for refund of all sums paid as taxes under protest, which represented the surtax on undistributed profits, as follows:

On or about July 15, 1937	$ 8,100.00
On or about September 15, 1937	16,199.99
On or about July 15, 1938	16,525.52

said claims representing the full amount of surtax on undistributed profits for the year 1936 which had been paid by the plaintiff up to and including the date on which said claims were filed; that up to and including the date on which the claim for $8,100.00 was filed, two installments of the tax disclosed by the original return filed had been paid and the claim therefor was limited to the sum of these two installments, or $8,100.00; that by September 15, 1937, the entire surtax on undistributed profits had been paid and claim therefor was made for the full amount of the surtax on undistributed profits disclosed by the original return filed in the sum of $16,199.99, which sum and claim is exclusive of the first claim amounting to the sum of $8,100.00; that after the payment of the additional tax disclosed by the Federal Revenue Agent's report resulting in an additional surtax on undistributed profits of $325.53, claim was made for the sum of $16,525.52, which claim is inclusive of the first two claims and includes the total surtax on undistributed profits for the year 1936.

9. That all three of the claims for refund heretofore described were disallowed by the Commissioner of Internal Revenue and official notice given plaintiff by registered letter dated the 9th day of December, 1938, a copy of the official notice of disallowance being hereto attached, marked Exhibit "A", and made a part of this complaint as fully as though set out in detail herein.

10. That all of the surtax on undistributed profits, and the whole thereof, was assessed and collected by the defendant erroneously, illegally and wrongfully in that:

(a) The Revenue Act of 1936 imposes a surtax on undistributed net income as defined in section 14 of said Revenue Act, which undistributed net income is calculated, after deducting as credits, dividends paid during the year and also a credit for contracts restricting the payment of dividends, as provided in Section 26(c)-1 of said Revenue Act.

(b) That in spite of the claims for refund already made no credit has been given the plaintiff for contracts restricting the payment of dividends as provided in Section 26(c)-1 of said Revenue Act, which if given would result in its having no undistributed net income and consequently no surtax on undistributed profits.

11. That in particular the Revenue Act of 1936 under Section 26(c)-1 permits credit to be taken against the calculation of undistributed net income for contracts restricting the payment of dividends, and reads as follows:

> "(c) *Contracts Restricting Payment of Dividends.* (1) Prohibition on Payment of Dividends.—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract

provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account."

12. That under date of May 20, 1909, the plaintiff was duly incorporated under the laws of the State of Utah having prior thereto filed with the Secretary of State for the State of Utah its articles of incorporation, since which date it has continued to be and at the present time is a corporation authorized to do business in the State of Utah under the provisions of said articles of incorporation.

13. That as a corporation under the laws of the State of Utah the plaintiff is subject to the laws of the State of Utah.

14. That under the law and ordinary business rules the plaintiff would have been able to pay dividends as evidenced by the following provisions of the laws of the State of Utah:

Section 18-2-16 RSU 1933—Powers of Corporations for Pecuniary Profit.

"The corporation in its name shall have power:

(1) To make all contracts necessary and proper to effect its purposes and conduct its authorized business.

(4) To disburse out of profits actually earned and on hand such dividends from time to time as the directors may deem prudent."

15. That the net earnings for the year 1936 of the plaintiff amounted to the sum of $64,541.78 from which the plaintiff was prohibited from declaring or paying any dividends by the following provisions of the laws of the State of Utah:

Section 18-2-17 RSU 1933—Dividends—Distribution of Capital Forbidden.

"No corporation shall make or pay any dividend except from the surplus profits arising from the business of the corporation and in the cases and manner allowed by law; nor divide, withdraw,

or in any manner except as provided by law pay to the stockholders or any of them, any part of the capital of the corporation."

Section 103-12-4 RSU 1933—Certain Acts Prohibited —By Directors.

"Every director of any stock corporation who concurs in any vote or act of the directors of such corporation or any of them, by which it is intended either:

(1) To make any dividend except from the surplus profits arising from the business of the corporation, and in the cases and manner allowed by law; or,

(2) To divide, withdraw or in any manner, except as provided by law, pay to the stockholders, or any of them, any part of the capital of the corporation;—is guilty of a misdemeanor.

Section 103-1-13 RSU 1933—"Felony," "Misdemeanor" Defined.

"A felony is a crime which is or may be punishable with death, or by imprisonment in the state prison. Every other crime is a misdemeanor."

Section 103-1-16 RSU 1933—Punishments for Misdemeanor.

"Except in cases where a different punishment is prescribed by law, every offense declared to be a misdemeanor is punishable by imprisonment in a county jail not exceeding six months or by a fine in any sum less than $300, or by both. In all cases where a corporation is convicted of an offense for the commission of which a natural person would be punishable as for a misdemeanor and there is no other punishment prescribed by law, such corporation is punishable by a fine not exceeding $1,000."

16. That as of December 31, 1935, the plaintiff's capital stock outstanding, consisting of 10,040 shares of the par value of $100.00 per share, was impaired to the extent of $217,699.01. This impairment of capital stock represented the accumulated deficit from operations of the corporation from January 1, 1932, to and including December 31, 1935. During the year 1936 its operating deficit was reduced by the sum of $64,541.78 representing the net earnings for the year 1936, but even after crediting said deficit with the 1936 earnings a deficit still remained amounting to the sum of $153,157.23, in consequence of which the plaintiff was prohibited by the statutes of the State of Utah from paying any dividends during that year.

17. That under Section 26(c)-1 of the Revenue Act of 1936 the plaintiff is entitled as a credit against its undistributed net income for an amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating the provisions of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends, and that its articles of incorporation duly filed prior to May 1, 1936, and the laws of the State of Utah in effect prior to May 1, 1936, together constitute a written contract, and that portion thereof comprising the laws of the State of Utah expressly deals with the payment of dividends, and that in view of the plaintiff's operating deficit at the beginning of the year and at all times during the year, even after reducing said operating deficit by the amount of the 1936 net income, said deficit still existed and the plaintiff therefore could not pay dividends during the year 1936 without violating the provisions of said contract.

18. That the amount of said credit allowed to plaintiff according to Section 26(c)-1 should be calculated as the excess of the adjusted net income over the aggregate of the amounts which can be distributed without violating the provisions of the contract, and that said credit should be calculated as follows:

Undistributed net income	$80,612.88
Aggregate amount of dividends which could be distributed within the taxable year	

without violating the provisions of the written contract heretofore referred to.. None

Amount of Credit.....$80,612.88

That after allowance of the above credit of $80,612.88 the surtax on undistributed profits, calculated as $16,525.52 on the undistributed net income before said credit would amount to zero.

19. That unless Sections 14 and 26 are so interpreted as to give credit to this plaintiff in determining its undistributed net income under the contract restricting payment of dividends as evidenced by its charter and the laws of the State of Utah, as set out in paragraphs 14 and 15 thereof, then said sections, and each of them, are unconstitutional in that:

(a) Said sections above named thereby nullify and render void and of no effect the laws of the State of Utah since said laws under said interpretation cannot be considered with and as a part of the written charter of plaintiff, which together constitute a written contract restricting the payment of dividends by plaintiff, which contract was executed prior to May 1, 1936.

(b) Said sections are, and each of them is, arbitrary, discriminatory and in conflict with the Fifth Amendment to the Constitution of the United States since said laws so interpreted allow to others than this plaintiff credit under written contracts restricting the payment of dividends, and disallow that same right to this plaintiff.

20. That since the date of said disallowance of the refund to plaintiff as demanded by it, the defendant has not paid said refund or any part thereof, so that there is now due and owing from defendant to the plaintiff the sum of $16,525.52, together with interest at six (6%) per cent per annum on the several installments collected by defendant from the date of payment of each respective installment.

WHEREFORE, plaintiff prays judgment against defendant for the sum of $16,525.52 and interest thereon at the rate of six (6%) per cent per annum from the dates of the payment of

the several installments as herein set out, or from such other date or dates as are legally allowable, together with plaintiff's costs incurred herein.

ROBERT L. JUDD,
PAUL H. RAY,
ACEL H. NEBEKER,
Attorneys for Plaintiff.
921 Kearns Building,
Salt Lake City, Utah.

Exhibit "A."

Office of Commissioner
of Internal Revenue

TREASURY DEPARTMENT
Washington

IT:C1:CC-4-CCP Dec. 9, 1938

Utah Hotel Company,
South Temple and Main Streets,
Salt Lake City, Utah.

In re: Claims for refund of $8,100.00, $16,199.99 and $16,525.52.

For the year 1936.

Sirs:

Reference is made to Bureau letter dated November 17, 1938, wherein you were informed that the claims for refund indicated above would be disallowed. The letter also stated the reasons for the proposed disallowance.

The claims having been disallowed or rejected on Schedule numbered 24530, this notice of disallowance is sent to you by registered mail as required by Section 1103 (a) of the Revenue Act of 1932.

Respectfully,

GUY T. HELVERING,
Commissioner,

By John R. Kirk,
Deputy Commissioner.

[APPENDIX—EX. A]

CERTIFICATE

STATE OF UTAH,
COUNTY OF SALT LAKE—ss.

I, W. B. WILSON, Clerk of the United States District Court in and for the District of Utah, hereby certify the foregoing and attached complaint to be a true and correct copy of the complaint on file in my office, docket number Civil 84, wherein Utah Hotel Company, a corporation, is plaintiff, and Ira N. Hinckley, Collector of Internal Revenue, District of Utah, is defendant.

I further certify that the defendant has not filed in my office up to the present time any pleading whatsoever.

IN TESTIMONY WHEREOF, I hereunto subscribe my name and affix the seal of said office in the city of Salt Lake, State of Utah, this 7th day of November, 1939.

W. B. WILSON, Clerk.

EXHIBIT "B."

UNITED STATES BOARD OF TAX APPEALS

Docket No. 96981

PEPPERS GASOLINE COMPANY, AN OKLAHOMA CORPORATION, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

PETITION

The above named petitioner hereby petitions for a review and redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency IT:E:7:8 HFS:90D dated November 7, 1938, and as a basis for this appeal alleges as follows:

1. The petitioner is a corporation duly organized under the laws of the State of Oklahoma, and for tax purposes is a citizen of the United States, with its principal place of business in room 3010 First National Bank Building, Oklahoma City, Oklahoma County, State of Oklahoma.

The return for the period here involved was filed with the Collector of Internal Revenue for the District of Oklahoma.

2. The notice of deficiency (copy of which is hereto attached marked Exhibit "A" for identification and by such reference made a part hereof) was mailed to the taxpayer on November 7, 1938.

3. The taxes in controversy are alleged to be normal income and surtax on undistributed profits taxes for the calendar year 1936, in the total sum of $36,341.68.

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) that the Congress of the United States was and is without constitutional authority to enact legislation which authorizes the Treasury Department to determine, levy and/or collect the proposed surtax on undistributed profits of the taxpayer in the year in question, *viz.*, 1936;

(b) that such surtax upon undistributed profits is not an income tax and does not come within any reasonable inclusion of authority conferred upon Congress by the 16th Amendment to the Constitution of the United States;

(c) that such surtax upon undistributed profits is a penalty placed upon the taxpayer for its failure to distribute earnings upon which all income tax otherwise legally due has been fully paid, and such penalty therefore makes unlawful distinction in classification among taxpayers, and violates the provisions of law which require uniformity in taxation;

(d) that to compel a taxpayer to distribute earnings to avoid such penalty, when debts (as here) of more than $150,000.00 (upon some of which large monthly payments are obligated by written contract) are outstanding against its business, which obligations and debts were made for betterments and improvements in such business (prior to the passage of the law requiring such distribution of earnings) denies to the taxpayer due process and the equal protection of the laws guaranteed to the taxpayer by the 5th Amendment to the Constitution of the United States;

(e) that this taxpayer had outstanding prior to May 1, 1936, valid written contracts pledging monthly payments to certain creditors of the taxpayer (from whom materials and equipment had been purchased for such betterments and improvements) which contracts could not be avoided or rescinded (true copies of which are hereto attached marked Exhibit "B" for identification and by such reference made a part hereof) and that by reason of the obligations imposed by such contracts at the respective dates of their execution, the taxpayer could not distribute earnings in violation of such obligations or assume (as is necessary in this case) a penalty of approximately 20% upon each dollar of its earnings as an additional bur-

den for its respect of such outstanding obligations, and to require the taxpayer to so perform upon the facts disclosed by these contracts, is to deprive the taxpayer of its property rights in contravention of the due process and equal protection of the laws guaranteed by the 5th Amendment to the Constitution of the United States;

(f) that the error upon the part of the Commissioner in attempting to determine, levy and collect surtax on undistributed profits, is one of law, and in which effort the Commissioner is without authority under the Constitution of the United States as hereinbefore more fully set forth; and,

(g) that such proposed surtax may be determined, levied and collected only when authorized by amendment to the present Federal Constitution.

5. That there is error in the determination of the net income in the said notice of deficiency upon which the determination of tax set forth in the said notice of deficiency is computed, in the following particulars, to-wit:

(a) The depreciation allowance made to the taxpayer upon its gasoline plant No. 4, located near Oklahoma City, Oklahoma, is made upon the application of a uniform percentage based upon an assumed useful life of eight (8) years; whereas the depreciation actually sustained should be determined in conformity with the rule stated in Art. 165, Reg. 45 (1918 Law) (restated in all subsequent regulations) and applied in *Rainbow Gasoline Corporation* v. *Commissioner,* 31 Board of Tax Appeals, page 1050, upon a unit of production method which in this case the petitioner affirms should be in that yearly proportion which the volume of gas processed in such year bears to the total volume of gas available (at the time of construction of the plant) to be ultimately processed therein.

That attached hereto and marked Exhibit "C" for identification and by such reference made a part hereof, is a statement in summary form which gives effect to the contention of the taxpayer upon depreciation allowance claimed for the year in question and in which sums so claimed its depreciation allowance should be made.

(b) That in addition to the failure of the Commissioner to allow petitioner adequate and proper depreciation, as hereinbefore set forth, the Commissioner has committed further error in requiring the petitioner during the year 1936, to capitalize $51,396.74 expended for the sole purpose of maintaining the processing capacity for which the plant was constructed and designed in order that the original investment might be returned through the period of its useful life and operative value. The petitioner complains of charges to investment while the property is becoming less valuable, with the inevitable result that when the investment is complete the property will be worthless. The petitioner therefore contends that it should be permitted to deduct as an operating expense, such amount so expended during said taxable year, notwithstanding the physical property so acquired had a useful life in excess of one year.

Wherefore, the petitioner respectfully asks that the complained of statutes (Sec. 14, Sec. 26(c) (1) and Sec. 26(c) (2), Revenue Act of 1936) which purport to authorize the determination levy and collection of surtax or surtaxes upon undistributed profits for the year or years in question, be held to be unconstitutional and that the petition be granted.

(a) depreciation allowance in conformity herewith; and,

(b) the deduction of the said $51,396.74 as an expense of maintaining the output of said plant during such taxable year; and it appearing that petitioner within three (3) years before the filing of this petition, has paid an income tax for 1936 in the total sum of $16,594.69, when under the law and facts the petitioner was not indebted in said year for Federal Income Tax in any sum whatsoever, this Honorable Board should therefore, in conformity with Section 809, Revenue Act of 1938, amending Section 322(d) of the Revenue Act of 1936, and of the Revenue Act of 1934, determine as a part of its decision that the said sum of $16,594.69 was so illegally overpaid.

Harry O. Glasser,
Attorney for Taxpayer,
805 Boardway Tower,
Enid, Oklahoma.

Approved:
Thos. F. Carey,
Oklahoma City, Oklahoma,
Auditor for Taxpayer.

State of Oklahoma,
County of Oklahoma—ss.

Charles C. Peppers being duly sworn states that he is President of the Peppers Gasoline Company, a corporation, the taxpayer named in the foregoing petition, has read the statements therein contained (and in the exhibits thereto attached) and the facts therein stated are true except such facts as are stated to be upon information and belief, and the allegations and statements so made affiant believes to be true.

Charles C. Peppers.

Subscribed and sworn to before me this 26th day of January, 1939.

Lydia Vacin,
Notary Public.

(Seal)

My commission expires June 23, 1939.

UNITED STATES BOARD OF TAX APPEALS

Washington

UNITED STATES OF AMERICA,
DISTRICT OF COLUMBIA—ss.

I, B. D. Gamble, clerk of the United States Board of Tax Appeals, hereby certify the foregoing and attached to be true and correct copies of the Petition in Docket Number 96981, wherein Peppers Gasoline Company, an Oklahoma corporation, is Petitioner and the Commissioner of Internal Revenue is Respondent.

In testimony whereof, I hereunto subscribe my name and affix the seal of said Board of Tax Appeals at the city of Washington in said District this 6th day of November, 1939.

B. D. Gamble, Clerk,
United States Board of Tax Appeals.

EXHIBIT "C."

No. 9207

IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

NORTHWEST STEEL ROLLING MILLS, INC., ***Petitioner,***

vs.

COMMISSIONER OF INTERNAL REVENUE, ***Respondent.***

Upon Petition to Review a Decision of the United States Board of Tax Appeals.

BRIEF OF PETITIONER.

EGGERMAN & ROSLING,
D. G. EGGERMAN,
WALSER S. GREATHOUSE,
Counsel for Petitioner.

1824 Exchange Building,
Seattle, Washington.

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IN THE UNITED STATES CIRCUIT COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 9207

NORTHWEST STEEL ROLLING MILLS, INC., *Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Upon Petition to Review a Decision of the United States Board of Tax Appeals.

BRIEF OF PETITIONER.

JURISDICTION.

This appeal involves a deficiency in income tax liability of petitioner for the calendar year 1936 and is from a decision of the United States Board of Tax Appeals entered February 17, 1939 (R. 18, 19), the decision being based upon the opinion of the Board disallowing petitioner a credit of $75,085.26 for contracts restricting dividend payments, which credit was claimed by petitioner in computing its surtax on undistributed profits under Sections 14 and 26 of the Revenue Act of 1936 (R. 14, 16-18). Petition had been filed with the Board of Tax Appeals for a redetermination of deficiency of income tax liability as set forth in a Notice of Deficiency from respondent Commissioner dated February 4, 1938 (R. 3-12). Respondent answered the petition, admitting that the taxes in controversy were as above indicated, and denying certain material allegations of the petition upon which petitioner sought a redetermination (R. 13). The Board of Tax Appeals had jurisdiction by virtue of Sec. 501, Revenue Act of 1934, c. 277, 48 Stat. 741, 26 USCA 272.

Findings of Fact and opinion of the Board of Tax Appeals were filed and decision was entered for respondent Commis-

sioner (R. 14-18). This appeal from the decision of the Board is pursuant to Section 1001-1003, Revenue Act, February 26, 1926, c. 27, 44 Stat. 109, 110, as amended by Sec. 1101, Revenue Act of 1932, c. 209, 47 Stat. 169, 286.

There is involved the validity of Sections 14 and 26 of the Revenue Act of 1936, pertinent provisions of which are as follows:

"Sec. 14. Surtax on Undistributed Profits.

"(a) Definition—as used in this title * * *

"(2) The term 'undistributed net income' means the adjusted net income minus the sum of the dividends paid credit provided by Section 27 and the credit provided in Section 26 (c), relating to contracts restricting dividends.

"Sec. 26. Credits of Corporations.

"In the case of a corporation, the following credits shall be allowed to the extent provided in the various sections imposing tax— * * *

"(c) Contracts restricting payment of dividends.—

"(1) Prohibition on payment of dividends.—An amount equal to the excess of the adjusted net income over the aggregate of the amount which can be distributed in the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount, only one shall be taken into account.

"(2) Disposition of profits of taxable year.—An amount equal to the portion of the earnings and profit of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year to be paid within the taxable year in discharge of a debt, or to be ir-

revocably set aside within the taxable year for the discharge of a debt); to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word 'debt' does not include a debt incurred after April 30, 1936."

STATEMENT OF THE CASE.

The questions involved are three-fold.

1. Is petitioner's corporate charter from the State of Washington, which charter was granted prior to May 1, 1936, and the general corporation law of the State of Washington, a written contract within the meaning of Section 26 of the Revenue Act of 1936, entitling petitioner to the credits allowed under that section?

2. Are Sections 14 and 26 arbitrary and discriminatory and an illegal interference by the federal government with state sovereignty if construed as disallowing a credit although petitioner's charter prohibits payment of dividends?

3. Are Sections 14 and 26 of the Revenue Act of 1936 arbitrary and discriminatory in that they deny credit to petitioner because of the provision of an *oral* contract with a creditor bank prohibiting the payment of dividends whereas they allow credit where similar provisions are contained in a *written* contract?

The Board of Tax Appeals found the following facts:

Petitioner corporation was organized in 1926 under the general corporation laws of the State of Washington and received its charter to carry on business from that state (R. 14).

Petitioner's operating deficit as of December 31, 1935, was $76,983.26. Its net income for 1936 was $76,049.71 (R. 14).

July 6, 1936, petitioner paid $85,000 to Seattle-First National Bank in retirement of its indebtedness (R. 15) evidenced by 90-day note. This indebtedness had been outstanding since

1926 (R. 14, 15) and at one time had been $150,000, subsequently reduced to $115,000, then to $85,000 (R. 15).

The Bank Examiners and the Executive Committee of the bank had criticized the amount of the loan and these criticisms had been recurrent. When the notes were renewed in January, 1934, a condition imposed by the bank on the renewal was that petitioner must pay $1,000 a month in reduction of principal *and* must pay on the indebtedness any available surplus in the treasury after payment of current operating expenses. Petitioner was given to understand that, in case of breach of this condition, the bank would apply for a receiver of petitioner's business (R. 15).

The evidence supports the above findings and also discloses some additional matters. Respondent admitted the allegation of the petition that petitioner is a corporation organized under the laws of the State of Washington (R. 3, 13). Beginning in 1926 petitioner borrowed large amounts from the Seaboard National Bank, subsequently a branch of the Seattle-First National Bank of Seattle (R. 35). From 1926 to 1936 petitioner was continuously indebted to the bank, the maximum amount of the indebtedness being $150,000 (R. 38). Before the depression petitioner had reduced the loan to $125,000. Subsequently the loan was reduced to $115,000 and stood at that figure for many years. When petitioner agreed to make $1,000 a month reduction in principal, the indebtedness stood at $115,000 (R. 38). This indebtedness was evidenced by a 90-day note which was renewed (R. 38, 39). The loan was subject of criticism by the Executive Committee of the bank and by the bank examiner from time to time (R. 39). In 1936 the bank received $1,000 a month on the indebtedness (R. 39). The bank declined to permit any additional capital outlay by the company until the indebtedness was paid (R. 40).

If petitioner had violated the bank's instructions prohibiting payment of any dividends, the bank would have put the company into receivership (R. 41). Mr. Howell of the bank had known the Goetz family for many years and relied upon what they said and believed the promises which they made on behalf of petitioner (R. 43).

Any available money in the treasury of petitioner was to be used for current operating expenses and any surplus was

to be used to repay indebtedness to the bank (R. 47). Mr. Howell repeatedly told Mr. Gotez that if there was any excess money it should be paid on the note at the bank (R. 50).

Mr. Howell also made it clear in verbal conversation with Mr. Gotez that petitioner company could not pay a dividend until the note to the bank was paid off (R. 41). The note was paid in July, 1936 (R. 41). The payment was made out of reduction of inventory (R. 50). Petitioner had never been in a position to pay the bank prior to that time. A deficit had been accumulating regularly since January 2, 1934 (R. 50, 49). It was stipulated that petitioner had an operating deficit as of December 31, 1935, of $76,983.26 (R. 71) and that the net income for the year 1936 was $76,049.71 (R. 71). *Petitioner had never been in a position to pay dividends* (R. 50).

SPECIFICATIONS OF ERROR.

1. Petitioner assigns error on the part of the United States Board of Tax Appeals in entering a decision for respondent and in deciding that petitioner was subject to any deficiency for the calendar year 1936.

2. The Board erred in determining that the charter and general corporation laws of the State of Washington are not a written contract within the meaning of Section 26 of the Revenue Act of 1936.

3. The Board erred in denying petitioner's contention that Sections 14 and 26 of the Revenue Act of 1936 are invalid and unconstitutional.

4. The Board erred in that its decision is not supported by the evidence and stipulation of facts and is contrary to law (R. 74-76, incl., 23, 24).

SUMMARY OF ARGUMENT.

1. The charter and corporation laws of the State of Washington constitute a written contract between petitioner, its stockholders, and the State of Washington. By virtue of such charter and state laws, petitioner was forbidden payment of dividends in the year 1936. It would have been an illegal act for petitioner to have distributed a dividend. Therefore, petitioner was entitled to a credit because it could not distribute within the taxable year as dividends any accumulation of earnings without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which contract expressly deals with the payment of dividends.

2. Assuming that the charter and corporation laws of the State of Washington are held not to be a written contract within the provisions of Section 26, Revenue Act of 1936, then the latter act is invalid and unconstitutional as being arbitrary, capricious and unjust and in violation of the Fifth Amendment of the Federal Constitution because it allows a credit to a corporation as to a *written* contract, but refuses such credit to a corporation that is helpless to make a distribution of dividends because of its charter and of the general corporation laws, and which, if it did make a dividend, would be doing an unlawful act. Furthermore, the Act constitutes an illegal interference by the federal government with state sovereignty, in contravention of the Tenth Amendment to the Federal Constitution in that the state has exclusive power and authority as to legislation of corporations incorporated under its jurisdiction and as to when such corporations may pay dividends, and the state has legislated in that regard. The federal legislation in this instance is an interference with the state in a sphere in which the state has sole jurisdiction.

3. There was an oral agreement with the bank prohibiting petitioner from paying dividends. It is arbitrary, unjust and an unconscionable exaction to disallow a credit to a corporation which has a binding *verbal* agreement prohibiting the payment of dividends while allowing the credit to a corporation which has a *written* agreement; and Sections 14 and 26, Revenue Act of 1936 are therefore unconstitutional and invalid.

ARGUMENT.

I.

PETITIONER WAS ENTITLED TO A CREDIT BECAUSE OF THE CHARTER AND GENERAL CORPORATION LAWS OF THE STATE PROHIBITING DISTRIBUTION OF A DIVIDEND.

Petitioner was incorporated in 1926 (Petitioner's Ex. 3; Articles of Incorporation, R. 58-66, Petitioner's Ex. 4; R. 67), "Under the general incorporation laws of the State of Washington" (R. 58), to exercise "such powers as are or may be granted or conferred by the general incorporation laws of the State of Washington * * *" (R. 63, 19th paragraph).

Thus, the Articles of Incorporation expressly refer to the general incorporation laws of the State of Washington. Those laws prior to May 1, 1936, and throughout the year 1936 provided in part as follows:

> "In computing the aggregate of the assets of the corporation, the Board of Directors shall determine and make proper allowance for depreciation and depletion sustained, and losses of every character. Deferred assets and prepaid expenses shall be written off, at least annually in proportion to their use as may be determined by the Board of Directors.
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> "4. *No corporation shall pay dividends,*
>
> "a. In cash or property, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock, after deducting from such aggregate of its assets the amount by which such aggregate was increased by unrealized depreciation in value or revaluation of fixed assets;
>
> "b. In shares of the corporation, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock.

"5. Cash dividends shall not be paid out of surplus due to or arising from,

"a. Any profit on treasury shares before resale; or,

"b. Any unrealized profits due to increase in valuation of inventory before sale; or

"c. The unaccrued portion of unrealized profits on notes, bonds or obligations for the payment of money purchased or acquired at a discount unless such notes, bonds or obligations are readily marketable, in which case they may be taken at their actual market value; or

"d. The unaccrued or unearned portion of any unrealized profit in any form whatever, whether in form of notes, bonds, obligations for the payment of money, installment sales, credits or otherwise * * *."

Uniform Business Corporation Act, Laws of 1933, page 785, Sec. 24 of the State of Washington; Rem. Rev. Stat. 3803-24 (2, 3, 4 and 5).

"If any dividend be paid in violation of Section 3803-24, or if any other unlawful distribution, payment or return of assets be made to shareholders,

"1. The directors who knowingly, or without making reasonable inquiry, voted in favor thereof shall be jointly and severally liable to the corporation in an amount equal to the amount of the dividends so paid and the distribution, payment or return of assets so made;

"2. Every shareholder who receives any such dividend or any such distribution, payment or return of assets, shall in the following instances be individually liable to the corporation in an amount equal to the amount so received by him:

"a. When no director is liable to the corporation as provided in Subdivision 1 of this section, or

"b. To the extent that the corporation is unable to obtain satisfaction after judgment is recovered against directors upon the liability imposed by Subdivision 1 of this section * * *"

Session Laws 1933, page 787, Sec. 25, Laws of the State of Washington; Rem. Rev. Stat. 3803-25.

Dividends paid in impairment of capital are *illegal.*

Sparling, Trustee, v. *General Discount and Mortgage Corporation,* 178 Wash. 663, 670, 35 P. (2d) 60; af. on rehearing 184 Wash. 387, 50 P. (2d) 1023.

It has been the uniform rule applicable to corporations incorporated in the State of Washington that *"the corporation could only pay dividends out of profits."*

Austin v. *Wright,* 156 Wash. 24, 27, 286 Pac. 48.

"'The rule of law that requires corporations to preserve their capital intact is alone sufficient to prevent the corporation from paying dividends *except out of profits.'* 5 Thompson, Corporation, (2d ed.) Sec. 5305."

Jorguson v. *Apex Gold Mine Co.,* 74 Wash. 243, 244, 245, 133 Pac. 465, 46 L. R. A. (ns) 637.

This rule is so stringently enforced that "any contract whereby a corporation seeks to diminish its capital stock, except in some way permissible by statute, contravenes public policy and is unenforceable."

Jorguson v. *Apex Gold Mine Co.,* 74 Wash. 243, 133 Pac. 465, 46 L. R. A. (ns) 637.

Capital stock is a trust fund and cannot be impaired by distribution to stockholders.

Brenneman v. *Whitehouse,* 85 Wash. 355, 358, 359, 148 Pac. 24;

Fox v. *Seattle Contact Co.,* 98 Wash. 557, 168 Pac. 185;

Gaunce v. *Schoeder,* 145 Wash. 604, 605, 261 Pac. 393.

Petitioner had an operating deficit as of December 31, 1935, in the sum of $76,983.26 (R. 14; R. 71). The net income for the year ending December 31, 1936, is $76,049.71 (R. 14; R. 71, 72). The note to the bank in the sum of $85,000.00 was paid July 6, 1936 (R. 15; R. 41; R. 49). This payment was made out of reductions of inventories (R. 50). Petitioner had not been in a position to pay the bank prior to July 6, 1936 (R. 50). *A deficit had been accumulating for many years and petitioner has never been in a position to pay dividends* (R. 50).

Since it would have been a violation of the laws of the State of incorporation for petitioner to have paid a dividend, are such laws "a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends?" If so, then a credit is allowable under Section 26, Revenue Act of 1936.

The Articles of Incorporation were executed February 11, 1926 (Petitioner's Ex. 3; R. 58, 66). These Articles were accepted by the State of Washington March 20, 1926 (R. 67), and thereby became a binding contract in writing.

> "It (the corporate charter) is a contract between the state and the corporation and its members; between the corporation and its stockholders, and between the stockholders themselves. This is true not only of charters conferred by special act but also of those which exist under general law."
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> Fletcher, Cyc. on Corporations, Vol. 7, Sec. 3657, pp. 792, 793, 794, and cases there cited.

This principle was established in *Trustees of Dartmouth College* v. *Woodward,* 4 Wheat. (U. S.) 518, 4 L. ed. 629, and reaffirmed in *Trustees of Jefferson College* v. *Washington & Jefferson College,* 20 L. ed. 550, 80 (U. S.) 190.

> "The articles of certificate do not alone constitute the charter, and determine the powers of the corporation *but they are to be taken in connection with the statutes.*"
>
> Fletcher Cyc. Corporations, (Perm. Edn.) Vol. 7, Ch. 42, Sec. 3635, p. 762.

The charter and by-laws of a corporation constitute a contract between the company and its stockholders *into which the statutes of the state of its incorporation enter and are controlling.*

> *Ainsworth* v. *SW Drug Corp.,* (C. C. A. 5) 95 F. (2d) 172, 173.

> "The relationship existing between a corporation and its stockholders is one of contract * * * in which the charter and by-laws of the corporation *and pertinent statutes*

of the state are embodied. (Jones v. *NW Edison Elec. Co.*, (C. C. A.), 144 Fed. 765, 770.)"

Schroeter v. *Bartlett Syndicate Bldg. Corp.*, (Cal.) 55 P. (2d) 1221.

"Where possible, we must endeavor to give effect to all provisions of the statute and certificate which are sufficiently clear and definite as to be reasonably understood and expressive of the agreement between the incorporator and between the corporation and its stockholders. *Such provisions are a constituent part of the contract entered into.*"

Yoakam v. *Providence Biltmore Hotel Co., et al.*, (D. C. R. I.) 34 F. (2d) 533, 541.

"The charter of a private corporation constitutes a contract, not only between the state and the corporation, the shareholders and the corporation, but also between the state and the shareholders. This is settled law. *Wilmington Rr.* v. *Reid*, 13 Wall. 264, 20 L. ed. 568; *Larabee* v. *Dolley*, (C. C.) 175 Fed. 365, p. 390; *Garey* v. *Mining Co.*, 32 Utah 497, 91 Pac. 369, 12 LRA (ns) 554; Cook on Corporations, (3rd ed.) Sec. 492 to 496, inclusive. *The transaction necessarily involves the assent of the shareholders.*"

Tyler v. *Dane County*, (D. C. Wisc.) 289 Fed. 843, 855, 856.

To the same effect:

Forman v. *A. B. Leach & Co., Inc.*, (D. C. N. Y.) 11 F. (2d) 454, 456;

Oregon Rr. & Nav. Co. v. *Oregonian Ry. Co.*, 130 U. S. 1, 21, 24, 25, 32 L. ed. 837, 840, 841, 842;

Republican Mountain Silver Mines, Ltd., v. *Brown*, (C. C. A. 8) 58 Fed. 644, 649, 650;

Sanderson v. *Salmon River Canal Co.*, 45 Idaho 234, 263 Pac. 32.

"Where corporations are organized under the general law, as is required in this state by Article 11, Sec. 2, of our Constitution, *the charter of a private corporation*

consists not only of the Articles of Incorporation, *but includes all general statutes applicable to that class of corporation, and all persons, whether stockholders or creditors, who have dealings with the corporation are conclusively presumed to do so with knowledge of its charter and of its charter rights* * * *."

Loveland & Co. v. *Doernbecher Mfg. Co.*, (Ore.) 39 P. (2d) 668, 673.

The Constitution of the State of Washington also requires that corporations be organized under the general law.

"Corporations may be formed under general law, but shall not be created by special act. All laws relating to corporations may be altered, amended or repealed by the Legislature at any time, and all corporations doing business in this state, may, as to such business, be regulated, limited or restrained by law."

Article 12, Sec. 1, Constitution of the State of Washington; Rem. Rev. Stat., Vol. 1, p. 479.

Thus the federal government and its agents must be *conclusively presumed* to know of the prohibitions imposed upon corporations in the State of Washington against the payment of dividends and it must be assumed that Congress likewise had knowledge of this fact and it would seem an unreasonable construction to place upon an enactment of Congress that a corporation would be allowed a credit if it paid a dividend when it had no right to do so, but would be disallowed the credit if it conformed to law which prohibited distribution of dividends. An interpretation which would place a premium on illegal acts should be avoided if consistent with a reasonable interpretation of the act.

For a general discussion of Section 26, Revenue Act of 1936, and of the legal principle that the charter is a contract, as applied to said section, see Paul & Mertens, *"Law of Federal Income Taxation,"* 1938 Cum. Supp., Vol. 3, Sec. 32-A, 43, pp. 350-354, incl.

Every element required under Section 26 for a credit exists in the instant case. No dividends could have been declared by petitioner without violating a provision of a written con-

tract (to-wit, the corporate charter which embodies the laws of the state of its incorporation) executed by the corporation prior to May 1, 1936 (the Articles of Incorporation were executed in 1926, approved by the state that year, and the corporation has proceeded pursuant to those articles ever since, the articles and state law being an executed contract not only between the state and the corporation, but also between the corporation and its stockholders, and between the stockholders and the state) which provision expressly deals with the payment of dividends (Rem. Rev. Stat. 3803-24, expressly deals with dividends and is "a constituent part of the contract entered into" as does the general law of the state as announced in court decisions).

Furthermore, there being constitutional questions raised as to the validity of the Act if such credit does not obtain, the statute should, if possible, be construed to allow the credit and thereby remove doubts as to its invalidity.

> "A statute must be construed, if fairly possible, so as to avoid not only the conclusion that it is unconstitutional, but also grave doubts upon that score, * * *."
>
> *Linder* v. *U. S.*, 69 L. ed. 819, 823, 268 U. S. 5, 17.

A construction is to be avoided which will raise a constitutional doubt and if ambiguity exists, it must be resolved in taxpayer's favor.

> *U. S.* v. *Jim Fuey Moy*, 241 U. S. 394, 401, 60 L. ed. 1061, 1064;
>
> *U. S.* v. *Havner*, (C. C. A. 8) 101 F. (2d) 161, 165.

If doubt exists as to the construction of a taxing statute the doubt should be resolved in favor of the taxpayer.

> *Hasett* v. *Welsh*, 303 U. S. 303, 314, 82 L. ed. 858, 867.

II.

THE ACT IS UNCONSTITUTIONAL UNLESS IT ALLOWS A CREDIT ARISING FROM THE CHARTER AND LAWS OF THE STATE.

"The state law makes the payment of dividends in such cases illegal and subjects the corporate officials to penalty for violation of its provisions. A strong argument may be made to the effect that the imposition of a graduated tax designed to force the commitment of illegal acts by directors of a corporation is arbitrary and unreasonable, and such a statute invades the powers reserved to the state to regulate the internal affairs of corporations * * *.

"* * * It may be that to avoid constitutional questions the credits granted by the statute to corporations having written contracts executed by the corporation prior to May 1, 1936, prohibiting the payment of dividends will, in the case of corporations organized prior to May 1, 1936, be held by the courts broad enough to cover situations in which the state law prohibits the payment of dividends."

Paul & Mertens, *"Law of Federal Income Taxation,"* Vol. 3, 1938 Cum. Supp., Sec. 32-A, 53, pp. 382, 383.

"Except insofar as they may be restrained by constitutional provisions, the legislatures of the several states, as the depositaries of the sovereign legislative power, have the inherent power to create corporations and to determine and prescribe the mode of incorporation, the purposes for which corporations shall be created, the powers which shall be conferred upon them, and the conditions under which they may be exercised."

14 C. J., "Corporations," Sec. 56, p. 94;
Briscoe v. *Ky. Bank,* 11 Pet. 257, 9 L. ed. 709;
In re Wyoming Coop. Assn., (D. C. Pa.) 198 Fed. 436.

"The general rule with regard to the respective powers of the national and the state governments under the

constitution, is not in doubt. The states were before the constitution, and, consequently, their legislative powers antedated the constitution. Those who framed and those who adopted that instrument meant to carve from the general mass of legislative powers, then possessed by the state, only such portions as it was thought wise to confer upon the federal government; and in order that there should be no uncertainty in respect of what was taken and what was left, the national powers of legislation were not aggregated but enumerated—with the result that what was not embraced by the enumeration remained vested in the states without change or impairment * * *. While the states are not sovereign in the true sense of that term, but only quasi sovereign, yet in respect of all powers reserved to them they are supreme—'as independent of the general government as that government within its sphere is independent of the state.' *Collector* v. *Day (Buffington* v. *Day)* 11 Wall. 113, 124, 20 L. ed. 122, 125. And since every addition to the national legislative power to some extent detracts from or invades the power of the state, it is of vital moment that, in order to preserve the fixed balance intended by the constitution, the powers of the general government be not so extended as to embrace any not within the express terms of the several grants or the implications necessarily to be drawn therefrom. It is no longer open to question that the general government, unlike the state, * * * possesses no *inherent* power, in respect of the internal affairs of the state; and emphatically not with regard to legislation."

Carter v. *Carter Coal Co.*, 80 L. ed. 1160, 1180, 298 U. S. 238, 294, 295.

To the same effect see:

Thurlow v. *Massachusetts*, 5 How. (U. S.) 504, 588, 12 L. ed. 256, 294;

59 C. J., "States," Sec. g, p. 20, and cases there cited;

Ex parte Guerra, (Vt.) 110 Atl. 224, 10 A. L. R. 1560;

American Coal Mining Co. v. *Special Coal, etc., Com.*, 268 Fed. 563, 565; Appeal dismissed, 258 U. S. 632, 42 Sup. Ct. 273, 66 L. ed. 801;

Central Union Tel. Co. v. *Indianapolis Tel. Co.*, (Ind.) 126 N. E. 628, 631, 632.

"No rule of law is better settled throughout the United States than that a state legislature has absolute power to enact, that is, pass, amend, or repeal, any law whatsoever it pleases, unless it is prohibited from so doing by either the state or federal constitutions; that the courts can only restrain the execution of a statute when it conflicts with either one or the other of said constitutions." *State* v. *Whisman*, (S. D.) 154 N. W. 707, 709.

To the same effect:

12 C. J., "Constitutional Law," Sec. 168, p. 749, and cases there cited;

State v. *Howell*, 85 Wash. 294, 297, 147 Pac. 1159;

Jacobson v. *Mass.*, 197 U. S. 11, 49 L. ed. 643, 649.

"A state, through its legislature, may regulate all corporations, without regard to their nature, just the same as they may regulate an individual, except in so far as the power to regulate is precluded by constitutional provisions or by provisions in the charter or franchise."

Fletcher, "Cyc. Corporations," Vol. 14, Ch. 59, Sec. 6684, p. 39.

"The power of taxation, which is expressly granted, may, of course, be adopted as a means to carry into operation another power also expressly granted. But resort to the taxing power to effectuate an end which is not legitimate, not within the scope of the constitution, is obviously inadmissible.

"'*Congress is not empowered to tax for those purposes which are within the exclusive province of the states.*' *Gibbons* v. *Ogden*, 9 Wheat. 1, 199, 6 L. ed. 23, 70."

U. S. v. *Butler*, 80 L. ed. 477, 490, 56 Sup. Ct. 312, 297 U. S. 1, 69, 102 A. L. R. 914, 927.

"'A statute must be construed, if fairly possible, so as to avoid not only the conclusion that it is unconstitutional, but also grave doubts upon that score,' * * *. Obviously, direct control of medical practice in the states is beyond the power of the federal government. Incidental

regulation of such practice by Congress through a taxing act cannot extend to matters plainly inappropriate and unnecessary to reasonable enforcement of a revenue measure. The enactment under consideration levies a tax, upheld by this court, upon every person who imports, manufactures, produces, compounds, sells, deals in, dispenses or gives away opium or cocoa leaves or derivatives therefrom, and may regulate medical practice in the states only so far as reasonably appropriate for or merely incidental to its enforcement."

"* * * The narcotic law is essentially a revenue measure, and its provisions must be reasonably applied with the primary view of enforcing the special tax. We find no facts alleged in the indictment sufficient to show that petitioner had done anything falling within definite inhibitions or sufficient materially to imperil orderly collection of revenue from sales. Federal power is delegated, and its prescribed limits must not be transcended even though the end seems desirable. The unfortunate condition of the recipient certainly created no reasonable probability that she would sell or otherwise dispose of a few tablets entrusted to her; and we cannot say that by so dispensing them, the doctor necessarily transcended the limits of that professional conduct with which Congress never intended to interfere."

Linder v. *U. S.*, 69 L. ed. 819, 823, 825, 268 U. S. 5, 17, 18, 22.

We submit that it is unconstitutional for Congress to impose drastic surtaxes for failure to distribute income which under the laws of the state a corporation is not permitted to distribute, and that this act constitutes an illegal federal interference with state power in so far as the act indirectly constitutes a regulation of corporate activity.

Furthermore, the tax is a penalty tax. The tax is not on income, but is dependent upon what the taxpayer does with its income already taxed, and therefore, the provisions are arbitrary, capricious and oppressive, and render the tax unconstitutional. The fact that Congress has failed to exempt stockholders from tax on dividends subsequently paid from profits

previously subjected to the surtax demonstrates that the tax is a penalty tax.

Montgomery, "Federal Income Tax Handbook," (1936) Ch. 20, pp. 703, 704.

III.

SECTION 26 OF THE REVENUE ACT OF 1936 IS UNCONSTITUTIONAL BECAUSE IT IS ARBITRARY AND DISCRIMINATORY, IN THAT IT PERMITS THE CREDIT AS TO A WRITTEN CONTRACT BUT DENIES A CREDIT AS TO AN ORAL CONTRACT OF THE SAME TERMS.

The primary object of the tax provisions in question was to induce the distribution of corporate surpluses as dividends to stockholders so that such dividends might be taxed.

> "The accumulation of surplus in corporations controlled by taxpayers with large incomes is encouraged by the present freedom of undistributed corporate income from surtaxes. Since stockholders are the beneficial owners of both distributed and undistributed corporate income, the aim, as a matter of fundamental equity, should be to seek equality of tax burden on all corporate income whether distributed or withheld from the beneficial owners. As the law now stands our corporate taxes dip too deeply into the shares of corporate earnings going to stockholders who need the disbursement of dividends, while the shares of stockholders who can afford to leave earnings undistributed escape current surtaxes altogether."
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> Presidential Message, March 3, 1936; House Report No. 2475, 74th Congress, 2d Session.

> "One of the so-called social objectives of the new tax provision, according to the President, was the forcing of corporate surpluses into the hands of stockholders."
>
> Montgomery, "Federal Income Tax Handbook," (1936-1937) Ch. 20, p. 703.

There is no dispute as to the agreement with the bank and the Board found that there was an agreement whereby

petitioner was required to pay $1,000.00 a month in reduction of the principal amount of the indebtedness "together with the payment on this indebtedness of any available surplus in the treasury of petitioner after the payment of its current operating expenses." And if petitioner did not do this, the bank would apply for the appointment of a receiver for petitioner's assets (R. 15). Admittedly this agreement was made prior to May 1, 1936. It was made to preserve the very existence of petitioner corporation.

One form of contract, whether oral or in writing, whether with the state or with a private party, is as good as another, provided that in each case the agreement expressly deals with the payment of dividends.

The section imposes an unreasonable discrimination under the Fifth Amendment between corporations which are in reality in substantially the same position.

> "Where the tax is so 'arbitrary and capricious as to cause it to fall' before that clause (the Fifth Amendment) or when the classification was so arbitrary as to have no relation to any special benefits derived by a particular group or clearly discriminatory as between persons in the same category it is invalid."
>
> *Brushaber* v. *Union Pac. Rr. Co.*, 60 L. ed. 493, 240 U. S. 1;
>
> *Nichols* v. *Coolidge*, 71 L. ed. 1184, 52 A. L. R. 1081, 274 U. S. 531.

> "An excise tax which contains arbitrary and unreasonable exemptions, or which attempts to discriminate unfairly between persons who properly fall within the same class, would encounter the objection that it lacks uniformity."
>
> *Pollock* v. *Farmers Loan, etc., Co.*, 158 U. S. 600, 39 L. ed. 1108;
>
> 26 R. C. L., p. 81, "Taxation," Sec. 59.

The act seeks to limit the credit to a written contract and to deny the credit entirely to a corporation utterly powerless

to distribute dividends because of an *oral* contract admittedly in existence prior to May 1, 1936. The Revenue Act in question, of course, became the law subsequent to that date. In seeking to confine the contract to a *written* one that must have been in existence prior to the enactment of the act, and in ignoring *oral* obligations by which the corporation had become committed prior to that date, the act constitutes an unjust, arbitrary and capricious discrimination, and is unconstitutional.

CONCLUSION.

It is reasonable and just to construe the Act as including the charter and corporation laws as a written contract entitling a corporation to a credit if prohibited from distributing dividends by reason of such charter and laws. If there is any doubt as to the construction of the Act, the doubt should be resolved in favor of taxpayer under the usual rule, and further, because question is raised as to the constitutionality of the Act.

If it be held that the charter is not a written contract, then the Act is arbitrary and discriminatory and constitutes an illegal interference with the State by the Federal Government.

In any event, the Act is discriminatory and invalid in drawing a distinction between a *written* and an *oral* contract prohibiting payment of dividends.

No deficiency should be assessed petitioner.

Respectfully submitted,

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No. 9207

IN THE UNITED STATES CIRCUIT COURT OF APPEALS
FOR THE NINTH CIRCUIT.

NORTHWEST STEEL ROLLING MILLS, INC., *Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

On Petition for Review of Decision of the United States Board of Tax Appeals.

BRIEF FOR THE RESPONDENT.

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IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

No. 9207

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vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

On Petition for Review of Decision of the United States Board of Tax Appeals.

BRIEF FOR THE RESPONDENT.

Opinion Below.

The only previous opinion in this case is the memorandum opinion of the United States Board of Tax Appeals (R. 14—18) which is unreported.

Jurisdiction.

This appeal involves income taxes for the year 1936 and is taken from the decision of the Board of Tax Appeals entered February 17, 1939. (R. 18-19.) The case is brought to this Court by petition for review filed May 10, 1939 (R. 19-25), pursuant to the provisions of Sections 1141-1142 of the Internal Revenue Code.

Questions Presented.

1. Whether the evidence sustains the taxpayer's contention that it could not legally have paid dividends during the taxable year 1936.

2. Even if taxpayer could not legally have paid dividends in 1936, is it entitled to credit under Section 26 (c) (1) of the Revenue Act of 1936 on the ground that the charter and state

statutes constitute a written contract prohibiting payment of dividends?

3. Whether there are any constitutional prohibitions against denial of the claimed credit under the circumstances of this case.

Statutes and Regulations Involved.

The statutes and regulations involved are set forth in the Appendix, *infra*, pp. 30-39 [65-72].

Statement.

The facts found by the Board of Tax Apeals (R. 14—15) are substantially as follows:

The taxpayer is a corporation organized in 1926 under the laws of the State of Washington. Its principal place of business is Seattle, Washington. (R. 14.)

Taxpayer's surplus by appraisal at the beginning and end of 1936 was $134,173.90. Its operating deficit as of December 31, 1935, was $76,983.26, and its net income for the year ended December 31, 1936, was $76,049.71. From 1926 to 1936 taxpayer was indebted in considerable sums to the Seattle First National Bank, Seaboard Branch. This indebtedness was evidenced by ninety day notes which were from time to time renewed. In January, 1934, this indebtedness amounted to approximately $115,000 and when taxpayer proposed to renew the notes, the officer of the bank who was handling the matter told the taxpayer's officers that a condition of renewal would be payment of $1,000 a month in reduction of the principal amount of the indebtedness, together with payments thereon of any available surplus remaining in taxpayer's treasury after payment of its current operating expenses. Taxpayer was given to understand by the officer of the bank in the course of these conversations that in case of a breach of this condition by taxpayer the bank would apply for the appointment of a receiver. This condition to renewal of the notes was not reduced to writing and no written contract was ever executed by taxpayer which dealt with payment of dividends. From January, 1934, to July, 1936, the amount of taxpayer's indebtedness to the bank was reduced to $85,000 and this amount was paid on July 6, 1936. (R. 14—15.)

In computing its surtax on undistributed profits under Section 26 of the Revenue Act of 1936, the taxpayer claimed a credit of $75,085.26 for contracts restricting dividend payments. The Commissioner disallowed the credit and the Board of Tax Appeals affirmed on review.

Summary of Argument.

The taxpayer has not discharged the burden resting upon it to prove that it could not legally have paid dividends in 1936, the taxable year, under the laws of Washington, the state of incorporation. The mere fact that taxpayer had an operating deficit at the close of 1935 does not compel the conclusion that it could not have declared dividends out of its net profits for 1936 so long as it had sufficient surplus, and the record does not disclose that it did not.

Assuming *arguendo* that taxpayer could not legally have paid dividends during 1936, still it is not entitled to the credit claimed by it under Section 26 (c) (1) of the Revenue Act of 1936 in the absence of a written contract executed by the corporation prior to May 1, 1936, which expressly deals with and prohibits payment of such dividends. No such contract is in evidence nor does the charter of the corporation, supplemented by the statutes of the State of Washington, where the company was incorporated, constitute such a contract within the meaning of the statute relied upon to support the credit.

There is no constitutional prohibition against denial of the claimed credit, for the law, as construed by the Commissioner and the Board, is a wholly reasonable attempt by Congress to check evasions of surtaxes on corporate earnings by subjecting them to surtax either in the hands of the stockholders or in the hands of the corporations themselves. Nor does the law, as so construed, constitute an unwarranted federal interference with the power of the states to control the distribution of corporate earnings, for Congress in raising revenue has incidental power to defeat obstructions to that incidence of taxes which it chooses to impose.

ARGUMENT.

I

The taxpayer has not proved that it could not legally have paid dividends during the taxable year 1936.

The taxpayer's case is bottomed upon the contention that under the laws of Washington, the state of incorporation, it could not have paid out as dividends any of the profits upon which the surtax here involved has been imposed. The Board of Tax Appeals, in sustaining the Commissioner, did not specifically answer this question but decided the case on the authority of its decision in *Crane Johnson Co.* v. *Commissioner*, 39 B. T. A. 1355, affirmed August 3, 1939 (C. C. A. 8th), not yet officially reported, but may be found in 1939 C. C. H., Vol. 4, ¶ 9652, involving a similar situation with respect to a North Dakota corporation.

Under the applicable Washington statute (Remington's Revised Statutes of Washington, Vol. 5, Title 25, Sec. 3803-24, see Appendix, *infra*), the taxpayer was prohibited from paying dividends in cash or property "except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock, after deducting from such aggregate of its assets the amount by which such aggregate was increased by unrealized apreciation in value or revaluation of fixed assets." Section 3803—25 (see Appendix, *infra*) imposes liabilities upon directors and stockholders declaring or receiving dividends paid in violation of law.

In the instant case, the record shows and the Board found that taxpayer's surplus by appraisal at the beginning and end of 1936, the taxable year, was $134,173.90; that its operating deficit as of December 31, 1935, was $76,983.26 and its net income for the year ended December 31, 1936, was $76,049.71; that taxpayer owed about $115,000 to a bank in 1934 which was reduced to $85,000 by July, 1936, at which time that amount was paid. Although the general manager of the taxpayer testified that the company was not in a position to pay

dividends, still such testimony is a mere conclusion which adds nothing to the facts in evidence.

It is submitted that those facts do not justify the conclusion that this taxpayer was prohibted by the Washington statute above referred to from paying out as dividends in 1936 its net profits of some $76,000. No certified financial statements are in evidence. Certainly the mere fact that taxpayer had an operating deficit at the beginning of the year would not prevent it from declaring dividends out of its profits during the taxable year so long as it had sufficient surplus and the record does not show that it did not. On the other hand, the record does show "surplus by appraisal" of some $134,000 and that would be more than sufficient to cover a dividend of $76,000 unless such surplus was created by "unrealized appreciation in value or revaluation of fixed assets" and the record does not show that it was.

It is therefore impossible to say on the record in this case that the taxpayer was not in a position to pay dividends during the taxable year 1936. Hence taxpayer has failed to sustain the burden of proof resting upon it in this proceeding. *New Colonial Co.* v. *Helvering,* 292 U. S. 435; *Welch* v. *Helvering,* 290 U. S. 111.

We have no quarrel with the Washington cases cited by the taxpayer on pages 11-12 of its brief on this appeal, although it may be noted in passing that none of them relates to the statute in question here which is part of the Uniform Business Corporation Act adopted in Washington effective January 1, 1934. Remington's Revised Statutes of Washington, Vol. 5, Sec. 3803-67. Moreover, it does not follow from cases like *Jorguson* v. *Apex Gold Mines Co.,* 74 Wash. 243, that the taxpayer could not have paid dividends in 1936, for there the court said (p. 244) that dividends can be paid only out of the profits or surplus earnings of the corporation and (p. 245) that there were no profits nor surplus out of which the dividend could be paid, while here, in the instant case, the taxpayer concededly made net profits of some $76,000 during the taxable year and had a "surplus by appraisal" of some $134,000. Indeed, in a New Jersey case *(Goodnow* v. *American Writing Paper Co.,* 73 N. J. Eq. 692) involving a statute similar to the Washington statute prior to the 1934 amendment, it was held

that a dividend may be declared out of profits even though the total assets of the company may not exceed its debts and the nominal share capital. See also *United Light & Power Co.* v. *Grand Rapids Trust Co.*, 85 F. (2d) 331, 336 (C. C. A. 6th), certiorari granted, 299 U. S. 534, dismissed per stipulation, 299 U. S. 618; Cook, Corporations, Eighth Ed., Vol. II, Sec. 546. pp. 1905-1908.

In the light of these considerations, it seems clear that the taxpayer has failed to prove that it was prohibited from declaring dividends from its 1936 profits either under the Uniform Business Corporation Act adopted in Washington in 1934 or under the cases cited by taxpayer which deal with the law prior to the 1934 amendment.

II.

Assuming *arguendo* that taxpayer could not legally have paid dividends in 1936, still it is not entitled to the claimed credit in the absence of a written contract expressly prohibiting payment of such dividends; and the corporate charter and State laws do not constitute such a contract within the meaning of Section 26 of the Revenue Act of 1936 upon which the taxpayer relies in support of its claim for credit.

The next point to be considered is whether the taxpayer is entitled to the claimed credit even if it had no legal right to distribute as dividends the net profits of 1936 which are here involved. The taxpayer urges (Br. 12-17) that its charter constitutes a "written contract executed by the corporation" within the meaning of Section 26 (c) (1) of the Revenue Act of 1936, which is the statutory provision relied upon by taxpayer in support of its claim for credit.

This question recently was passed upon by the Circuit Court of Appeals for the Eighth Circuit in *Crane Johnson Co.* v. *Commissioner, supra.* In deciding in favor of the Government, the court pointed out that for some purposes the charter of a corporation may be said to be a contract with the state (*Dartmouth College* v. *Woodward,* 4 Wheat. 517), and the laws, constitutional or statutory, of the state of incorporation may become part of the charter (see *Ainsworth* v. *Southwestern Drug Corp.*, 95 F. (2d) 172, 173 (C. C. A. 5th); *Jones* v. *Missouri-Edison Electric Co.*, 144 Fed. 765, 770 (C. C. A. 8th)).

The court then referred to the North Dakota statutes relating to payment of dividends which are similar to the Washington statute here involved and concluded that such statutes do not establish a contract executed by the corporation expressly dealing with payment of dividends within the meaning of Section 26 (c) (1) of the Revenue Act of 1936; and in that connection the court said that under the North Dakota statutes the liability in respect of improper dividends is purely one between the directors and the creditors so that "the corporation itself has made no written contract affecting its right to declare dividends."

The reasoning of the Eighth Circuit in the *Crane Johnson* case is fully applicable in the instant case for the corporate charter in the instant case (R. 58-66) contains no specific provisions as to payment of dividends and taxpayer has pointed out no provision of the applicable Washington statute (see Appendix, *infra)* imposing liability on the corporation itself as distinguished from liabilities of directors or stockholders in respect of dividends paid in violation of law.

It is submitted that taxpayer is in effect attempting to distort the meaning and scope of Section 26 (c) (1) so as to include therein a credit in respect of amounts paid in discharge of its indebtedness to the bank pursuant to an oral understanding, which amounts would be allowable if at all under Section 26 (c) (2), see Appendix, *infra,* but clearly are excluded therefrom by the requirement with respect to a written contract which concededly did not exist between the corporation and the bank. (R. 17-18, 31.) It is thought equally clear that Congress did not intend to include credits such as here claimed under the provisions of Section 26 (c) (1), and the Eighth Circuit so indicated in the *Crane Johnson* case, *supra,* saying with regard thereto:

> It is worthy of note that an analogous provision is found in Sec. 26 (c) (2) of the Revenue Act of 1936, which allows a credit of an amount equal to the portion of the earnings and profits of the taxable year which is required "by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the

taxable year for the discharge of a debt; to the extent that such amount has been paid or set aside." Clearly, this provision relates to a corporate undertaking to discharge a certain obligation out of earnings, and not to any statutory provisions. These similar provisions should be construed by the same rule.

Furthermore, if the meaning of Section 26 (c) (1) be considered doubtful, then reference should be made to the legislative history *(Taft* v. *Commissioner,* 304 U. S. 351, 355), which makes the Congressional purpose perfectly plain.

The legislative history of the undistributed profits tax imposed by the Revenue Act of 1936 supports the view that Congress did not intend to give special treatment to corporations which had deficits and were prohibited by state law from distributing dividends.[1] The Bill as introduced into the House contained three distinct provisions designed to relieve corporations which had a deficit or which for various reasons could not or should not pay dividends. Section 14 (a) provided that if the accumulated earnings and profits of the corporation as of the close of the taxable year (computed without diminution by reason of the distribution during the taxable year of earnings and profits, or by reason of the taxes imposed by Title I of the Act) were less than the adjusted net income, the tax should be computed in a different manner. This provision was intended to relieve corporations having a deficit. Section 15 was designed for the relief of corporations having outstanding contracts with respect to dividends, and Section 16 was intended for the relief of corporations having an outstanding indebtedness. (H. R. 12395, 74th Cong., 2d Sess., Secs. 14, 15 and 16).

In explanation of those provisions the Committee on Ways and Means stated (H. Rep. No. 2475, 74th Cong., 2d Sess., pp. 8-9):

EXCEPTIONS FROM GENERAL PLAN.

It has been recognized that in certain cases corporations cannot pay out dividend or that sound policy demands the nonpayment of dividends. Therefore, in certain

[1] See also the analysis of the legislative history of Section 26 (c) (1) contained in *Crane-Johnson Co.* v. *Commissioner, supra,* 38 B. T. A. 1355, 1364-1368.

cases, a flat rate of tax is imposed on corporate incomes, or parts thereof, in lieu of the undistributed profits tax proposed in the general case.

Deficits.—For example, section 14 of the bill provides that corporations with a deficit shall pay a tax of 22½ percent on the amount of earnings necessary to make up this deficit and only come under the new plan in respect to earnings in excess of this deficit, and in excess of the tax paid at the 22½-percent rate. This rule is more accurately stated in the section.

Contracts not to pay dividends.—In section 15, a similar treatment is accorded in respect to that part of corporate net income that cannot be paid out in dividends without violating a written contract in existence prior to March 3, 1936.

Debts.—In section 16 similar relief is given in case of certain debts which are in excess of the accumulated earnings and profits.

It is also provided that sections 14, 15 and 16 noted above shall not operate to increase the tax which would be payable without the application of such sections. A corporation, however, cannot use more than one of the relief provisions just cited but must use the one which will result in the smallest tax.

The Committee on Finance of the Senate substituted for the graduated undistributed profits tax a flat surtax of 7% on undistributed profits. It also struck out Sections 14, 15 and 16 of the House Bill, but in Section 26 (c) (1) retained the principle of Section 15 of that Bill affording relief to corporations under contract not to pay dividends.

In explanation of these changes the Committee on Finance said (S. Rep. No. 2156, 74th Cong., 2d Sess., pp. 12-13, 15):

SURTAX ON UNDISTRIBUTED PROFITS.

Section 14 of the committee bill imposes a surtax of 7 percent upon the amount of the undistributed net income of corporations. This, together with the normal tax on corporations, is a complete substitution for the undistributed-profits tax provision of the House Bill. Instead of having a graduated undistributed-profits tax like the

House bill with rates ranging as high as 42.5 percent, your committee has adopted a flat rate of 7 percent. By this moderate rate your committee has eliminated most of the complicated relief provisions in the House bill relating to debt and deficit corporations. However, the principle of the House bill affording relief to corporations which are unable to pay dividends because of express prohibitions in contracts entered into prior to March 3, 1936, have been retained for the purpose of the 7-percent undistributed-profits tax.

The term "undistributed net income" is defined in the bill to mean the adjusted net income minus (1) dividends paid during the taxable year, and (2) the amount of the adjusted net income which the corporation is prohibited by contract as defined in section 26 (c) from paying as dividends during the taxable year. The adjusted net income consists of the net income of the corporation reduced by the following:

(1) The normal tax on corporations imposed by section 13;

(2) Interest on United States and Government obligations;

(3) The amount allowed as a credit to a bank holding company affiliate under section 26 (d).

* * * * * * * *

SECTION 26. CREDITS OF CORPORATIONS.

This section sets forth certain credits allowed to corporations in computing the various taxes imposed under title 1. In general, they are as follows:

* * * * * * * *

(3) Contracts not to pay dividends: This credit is in principle similar to a relief provision allowed in the House bill for the purpose of the undistributed-profits tax imposed by that bill. It is allowed as a credit in computing undistributed net income for the purpose of the surtax on undistributed profits imposed by section 14 and in computing retained net income for the purpose of the tax imposed by section 102.

* * * * * * * *

An amendment to Section 26 (c) on the floor of the Senate restored the credit allowed to corporations under contract

to pay indebtedness which had been contained in Section 15 of the House bill. See Section 26 (c) (2) of the Revenue Act of 1936 (Appendix, *infra*, p. 66); Cong. Record, Vol. 80, Part 8, 74th Cong., 2d Sess., pp. 8790-8791, 9071. A graduated rate was also substituted for the flat surtax rate which the Senate Finance Committee had adopted. But no provision for the relief of deficit corporations analogous to Section 14 of the House Bill was restored to the Bill. See H. Conference Rep. No. 3068, 74th Cong., 2d Sess., pp. 2-4. See also Cong. Record, *supra*, p. 9071.

By a change in the definition of a dividend in Section 115 (a) of the Revenue Act of 1934, the Bill as passed permitted dividends paid credit to deficit corporations which actually distributed current earnings (see section 27 of the Revenue Act of 1936, U. S. C. Supp. IV, Title 26, Sec. 27); but none was allowed to deficit corporations which did not distribute.

Thus the failure of Congress to provide specifically for the allowance of a credit to corporations which had a deficit and were prevented by state law from paying out dividends appears to have been deliberate. Sectoin 14 of the House Bill would have given them relief but the Bill as finally enacted did not do so. It appears, moreover, that the purpose of the Senate in making the change was to eliminate the necessity of determining when there was a deficit, for, in explaining Section 115 (a) the Committee on Finance said (S. Rep. No. 2156, *supra*, p. 18):

> SECTION 115 (A). DIVIDENDS OUT OF CURRENT EARNINGS
>
> In order to enable corporations without regard to deficits existing at the beginning of the taxable year to obtain the benefit of the dividends paid credit for the purposes of the undistributed profits surtax, section 115 (a) changes the definition of a dividend so as to include distributions out of the earnings or profits of the current taxable year. The amendment simplifies the determination by providing that distributions during the year, not exceeding in amount the current earnings, are dividends constituting taxable income to the shareholder and a dividend paid credit to the corporation. As respects such dividends the complicated determination of accumulated earnings or profits is rendered unnecesary.

Attention is also called to the fact that Senator Walsh, a member of the Senate Finance Committee stated on the floor of the Senate that the Bill did not afford relief to corporations which were prevented by state law from declaring dividends except from earnings. His statement was as follows (Cong. Record, Vol. 80, Part 8, *supra*, p. 9058):

> Again, the laws of 36 States prohibit corporations chartered by them from making a dividend distribution if their capital is impaired. Under the proposed undistributed-profits tax, corporations affected by these provisions would be heavily penalized by the Federal tax for keeping within the law. The House bill taxes these corporations a flat rate on their net income of 22½ percent, regardless of their dividend policy.

It should also be noted that when the Bill which subsequently became the Revenue Act of 1938 was reported to the House of Representatives, the Committee on Ways and Means stated that one of the principal objections to the surtax on undistributed profits imposed by the Revenue Act of 1936 was that it was unfair to corporations with impaired capital which under state law cannot legally declare dividends. It was for that and other reasons that Congress substantially modified the undistributed profits tax imposed by the Revenue Act of 1938, c. 289, 52 Stat. 447. (H. Rep. No. 1860, 75th Cong., 3d Sess., pp. 3-4.) No provision analogous to Section 26 (c) (2) appears in that Act but certain relief for deficit corporations was afforded by the consent dividends credit provided for in Section 28 of that Act. With reference to that section the Committee made the following statement (H. Rep. No. 1860, *supra*, p. 24):

> SECTION 28. CONSENT DIVIDENDS CREDIT.
>
> One of the principal objections which has been urged to any form of corporation tax measured by undistributed profits has always been that many corporations, for a variety of reasons, find it difficult, if not impossible, in

---

[illegible] the hearings before both Committees of Congress, attention was repeatedly called to the situation of companies located in such states. Hearings before the Committee on Ways and Means, House of Representatives, 74th Cong., 2d Sess., pp. 101-102, 836-837, 842, 846-847; Hearings before the Committee on Finance, United States Senate, 74th Cong., 2d Sess., on H. R. 12395, pp. 234, 269, 282, 417.

certain situations to declare dividends in cash or scrip or to distribute taxable stock dividends. Section 28 of the bill is intended to provide a method whereby such a corporation, with the cooperation of its shareholders, may obtain the tax benefits incident to actual distribution without violation of any contractual commitment or any rule of law which might prevent it, in whole or in part, from distributing its earnings and without depriving the Government of the revenue which would flow from the receipt of dividends by the shareholders.

Thus the legislative history of the Act supports the view that the failure of Congress to provide specifically for the relief of deficit corporations was deliberate and that it did not consider that the provisions granting relief to corporations having a written contract executed by them not to pay dividends afforded relief to corporations prohibited by state law from making distributions except from earnings.

The Bureau of Internal Revenue has consistently held that the charter of a corporation does not constitute a written contract executed by the corporation within the meaning of Section 26 (c) of the Revenue Act of 1936. Article 26-2 of Regulations 94, *infra,* promulgated under the statute here involved so provides. See, also, T. D. 4674, XV-2 Cum. Bull. 53, 58 (1936). In I. T. 3016, XV-2 Cum. Bull. 73 (1936), it was specifically held that a corporation which was restricted by state law from paying dividends while its capital remained impaired was not entitled to special treatment under Section 26 (c) (1).

Clearly Congress did not intend that the right to the credit should depend upon or vary in accordance with state laws. The situation here is not unlike that in *Lyeth* v. *Hoey,* 305 U. S. 188, where the court said (p. 194):

> In dealing with the meaning and application of an act of Congress enacted in the exercise of its plenary power under the Constitution to tax income and to grant exemptions from that tax, it is the will of Congress which controls, and the expression of its will, in the absence of language evidencing a different purpose, should be interpreted "so as to give a uniform application to a nation-

wide scheme of taxation." *Burnet* v. *Harmel*, 287 U. S. 103, 110. Congress establishes its own criteria and the state law may control only when the federal taxing act by express language or necessary implication makes its operation dependent upon state law. *Burnet* v. *Harmel*, *supra*. See *Burk-Waggoner Oil Assn.* v. *Hopkins*, 269 U. S. 110, 111, 114; *Weiss* v. *Wiener*, 279 U. S. 333, 337; *Morrissey* v. *Commissioner*, 296 U. S. 344, 356. Compare *Crooks* v. *Harrelson*, 282 U. S. 55, 59; *Poe* v. *Seaborn*, 282 U. S. 101, 109, 110; *Blair* v. *Commissioner*, 300 U. S. 5, 9, 10. There is no such expression or necessary implication in this instance. * * *

There is no expression or implication in Section 26 (c) (1) which would require allowance of the credit in one state and disallowance in another, depending upon their peculiar laws respecting dividend payments. On the other hand, Congress clearly had in mind and intended to establish a uniform rule which would operate without regard to state laws.

Taxpayer urges (Br. 17) that in case of doubt, the statute must be construed in favor of the taxpayer; but not only does the meaning of Section 26 (c) (1) appear plain when applied to the facts in the instant case, but even were it otherwise, still the rule as to resolving doubts against the Government does not apply where exemptions, special privileges or deductions are claimed (*Helvering* v. *Inter-Mountain Life Insurance Co.*, 294 U. S. 686, 689) and in such cases the taxpayer must bring himself squarely within the scope of the statute relied upon to support the deduction.

In the light of these considerations, it seems clear that the claimed credit was properly denied in the instant case.

III.

There is no constitutional prohibition against denial of the claimed credit.

Taxpayer takes the position (Br. 18-23) that the provisions of the law imposing a surtax on undistributed profits are unconstitutional unless construed so as to allow credits such as claimed in this case; also (Br. 23-25) that Section 26 of the Revenue Act of 1936 is arbitrary and discriminatory,

in that it permits credit as to a written contract but denies credit as to an oral contract of the same terms.

Taxpayer also made these contentions before the Board of Tax Appeals which held them without merit upon the authority of the Board's decision in *Crane Johnson Co.* v. *Commissioner, supra,* which, as above pointed out, has now been affirmed by the Circuit Court of Appeals for the Eighth Circuit. In that case, the taxpayer urged on appeal that if construed to tax a corporation because it failed to do an unlawful and criminal act, the statute violates the Fifth Amendment. But the court said that since no North Dakota statute made it a crime to declare a dividend out of capital, the taxpayer was urging the court to decide a question of constitutional law based upon a hypothetical set of facts, which is not permissible, citing *Tennessee Pub. Co.* v. *Amer. Bank,* 299 U. S. 18; *Cincinnati* v. *Vester,* 281 U. S. 439; *Anniston Mfg. Co.* v. *Davis,* 301 U. S. 337.

The situation in the instant case is substantially similar to the one in the *Crane Johnson Co.* case, for here there appears to be no Washington statute making it a crime to declare dividends out of capital, and moreover, as shown under Point I of this brief, the record herein does not disclose that the net profits of some $76,000 which have been subjected to surtax could not legally have been declared out as dividends.

Moreover, as also pointed out by the court in the *Crane Johnson* case, *supra,* "Congress has the power to levy a tax on corporate net income even though there be an impairment of capital." *Willcuts* v. *Milton Dairy Co.,* 275 U. S. 215, 220.

Taxpayer says (Br. 22) that the act here under discussion constitutes an illegal federal interference with state power to control the distribution of corporate earnings; but in so contending, taxpayer not only ignores the *Milton Dairy Co.* case, *supra,* but also the more recent decision of the Supreme Court in *Helvering* v. *Nat. Grocery Co.,* 304 U. S. 282, where the court sustained the constitutionality of Section 104 of the Revenue Act of 1928 as applied to corporations availed of for the purpose of preventing the imposition of surtaxes upon its shareholders. In that connection the court said (pp. 286-287):

It is said that the statute violates the Tenth Amendment because it interferes with the power to declare or to withhold dividends—a power which the State conferred upon the corporation. The statute in no way limits the powers of the corporation. It merely lays the tax upon corporations which use their powers to prevent imposition upon their stockholders of the federal surtaxes. "Congress in raising revenue has incidental power to defeat obstructions to that incidence of taxes which it chooses to impose." *United Business Corp.* v. *Commissioner,* 62 F. (2d) 754, 756

And in *United Business Corp.* v. *Commissioner,* 62 F. (2d) 754 (C. C. A. 2d), cited by the Supreme Court in the *Nat. Grocery Co.* case, *supra,* the court said (p. 756):

> * * * companies may accumulate what profits they please so long as they do not do so to defeat the fiscal policies of the United States. Their business, whose regulation is wholly for the states, does not include the manipulation of dividends to avoid taxes; by definition that has nothing to do with the normal management of their affairs. Congress in raising revenue has incidental power to defeat obstructions to that incidence of taxes which it chooses to impose.

See also *Almours Securities* v. *Commissioner,* 91 F. (2d) 427, 429 (C. C. A. 5th), certiorari denied, 302 U. S. 765, rehearing denied, 303 U. S. 666.

In the light of those decisions, there seems no merit to the contention that Congress, by levying a surtax at graduated rates on undistributed net income, has exceeded its constitutional powers and violated the Tenth Amendment merely because credits are not allowed in respect of all restrictions existing under state law. The taxpayer has cited no case and we know of none where it has been held that deductions or credits must be allowed in cases such as here presented merely because disallowance might in some measure interfere in the affairs of a corporation regulated by state law. In this connection, it seems not inappropriate to note that the Supreme Court in cases decided during its last term has reconsidered and narrowed the doctrine of implied immunities of either gov-

ernment, state or national, and its instrumentalities from taxation by the other. *Graves* v. *N. Y., ex rel. O'Keefe,* 306 U. S. 466; *State Tax Comm'n* v. *Van Cott,* 306 U. S. 511.

Taxpayer also says (Br. 22) that "the tax is a penalty tax" and hence unconstitutional. But even assuming *arguendo* that the tax may in some measure constitute a penalty in that it is imposed in respect of profits which are not distributed, still it is settled that this in itself would not make the law unconstitutional. *Helvering* v. *Nat. Grocery Co., supra,* where the court said (pp. 288-289) that the penal nature of the imposition there in question did not prevent its being valid, as the tax was otherwise permissible under the Constitution. Cf. also *Helvering* v. *Mitchell,* 303 U. S. 391; see *United States* v. *Butler,* 297 U. S. 1, 61. In any event, it is thought that the imposition here involved is a true tax intended to raise revenue for governmental purposes and not an attempt to regulate the activities of state corporations under the guise of a tax. See report of Committee on Ways and Means, H. Rep. No. 2475, 74th Cong., 2d Sess., pp. 1-3, quoting from the message of the President dated March 3, 1936, from which it clearly appears that the purpose of the law was to check evasions of surtaxes on corporate earnings by allowing them to remain undistributed.

It is settled that Congress may pass measures reasonably calculated to prevent avoidance of taxes (cf. *Helvering* v. *City Bank Co.,* 296 U. S. 85; *Reinecke* v. *Smith,* 289 U. S. 172) and it is submitted that the tax herein involved, far from being an evidence of despotism, is a wholly reasonable attempt to prevent avoidance of tax.

Moreover, there is no merit to the contention of taxpayer (Br. 25) that the act is unconstitutional to the extent that it allows credits in respect of written contracts and denies them as to oral contracts with the same terms. Deductions or credits of this type are a matter of legislative grace within the sound discretion of Congress *(New Colonial Co.* v. *Helvering, supra),* and the taxpayer is in no position to complain if this grace was not extended to cover it. As pointed out in the opinion of the Board of Tax Appeals in the *Crane Johnson Co.* case, *supra,* p. 1360, the due process limitations on the taxing power are that the means be appropriate to the end *(Helvering* v.

City Bank Co., supra) and that the end be taxation rather than confiscation. *Brushaber* v. *Union Pac. R. R.*, 240 U. S. 1. Since, as above pointed out, the objective of the instant statute is to check evasions, it seems clear that the taxpayer may not complain because in certain instances corporations unable for other reasons to distribute their income are expressly exempted or are allowed deductions or credits having a similar effect, so long as the law, read as a whole in the light of its purpose, is not unduly harsh nor unreasonable. Cf. *Burnet* v. *Wells*, 289 U. S. 670; *LaBelle Iron Works* v. *United States*, 256 U. S. 377; *Graham & Foster* v. *Goodcell*, 282 U. S. 409.

As above pointed out, we question whether any failure to provide for a deduction or credit could be said to violate the Constitution even if considered to amount to an arbitrary classification because another deduction was granted which could also have been omitted, since all deductions are discretionary. But even if we are wrong in that view, we submit that there was a rational basis for the distinctions between written and oral contracts and between ordinary written contracts and particular state statutes relating to payment of dividends. It is a comparatively easy matter for the Bureau of Internal Revenue to ascertain whether an ordinary written contract prohibits payment of dividends. But it would be an almost insuperable burden for the Bureau to determine the validity and scope of oral contracts of that nature; and it would be almost as difficult for the Bureau to examine corporate charters in the light of the varying and complex state laws appertaining thereto as well as the financial histories of the corporations, in order to determine the right of a given taxpayer to credit. The tax laws are based largely upon practical considerations and may not always embody perfect economic theory. *Weiss* v. *Wiener*, 279 U. S. 333, 335; *Fraser* v. *Commissioner*, 25 F. (2d) 653, 654 (C. C. A. 2d).

See also *Crane Johnson Co.* v. *Commissioner, supra*, 38 B. T. A. 1355, 1360-1361, for additional reasons why the law, as construed by the Commissioner, is considered reasonable under the circumstances.

In conclusion, we submit that the law in question is a wholly reasonable effort to check evasions of surtaxes and viewed in that light there is no basis for the taxpayer's contention

that it is unreasonable and unjustly discriminatory in its application to the taxpayer and other corporations similarly situated. Cf. *Crane Johnson Co.* v. *Commissioner, supra; Co-operative Publishing Co.* v. *Commissioner,* 40 B. T. A. No. 70.

Conclusion.

The decision of the Board of Tax Appeals is correct and should be affirmed.

Respectfully submitted,

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September, 1939.

Appendix.

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) Definitions.—As used in this title—

* * * * * * * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

* * * * * * * *

(U. S. C. Supp. IV, Title 26, Sec. 13a.)

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall

be allowed to the extent provided in the various sections imposing tax—

* * * * * * * *

(c) Contracts Restricting Payment of Dividends.

(1) *Prohibition on payment of dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) *Disposition of profits of taxable year.* — An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "Debt" does not include a debt incurred after April 30, 1936.

(3) *Double credit not allowed.*—If both paragraph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

* * * * * * * *

(U. S. C. Supp. IV, Title 26, Sec. 26.)

Remington's Revised Statutes of Washington, Vol. 5, Title 25, c. 1-A:

§3803-24. *Capital carried as liability—Computation—Dividends how paid.*

1. Every corporation shall carry upon its books as a liability the amount of its capital stock as defined in section 3803-1, subdivision 10.

2. Amounts of surplus arising from an unrealized appreciation or revaluation of fixed assets shall be shown on the books of the corporation as a separate item apart from surplus profits or paid-in surplus.

3. In computing the aggregate of the assets of the corporation, the board of directors shall determine and make proper allowance for depreciation and depletion sustained, and losses of every character. Deferred assets and prepaid expenses shall be written off at least annually in proportion to their use as may be determined by the board of directors.

4. No corporation shall pay dividends,

a. in cash or property, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock, after deducting from such aggregate of its assets the amount by which such aggregate was increased by unrealized appreciation in value or revaluation of fixed assets;

b. in shares of the corporation, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock.

5. Cash dividends shall not be paid out of surplus due to or arising from,

a. any profit on treasury shares before resale; or

b. any unrealized profits due to increase in valuation of inventories before sale; or

c. the unaccrued portion of unrealized profits on notes, bonds, or obligations for the payment of money purchased or acquired at a discount unless such notes, bonds,

or obligations are readily marketable, in which case they may be taken at their actual market value; or

d. the unaccrued or unearned portion of any unrealized profit in any form whatever, wherther in form of notes, bonds, obligations for the payment of money, installment sales, credits or otherwise.

6. Subject to the limitations contained in this section, a dividend may be declared in shares of the corporation whenever the board of directors so determine: *Provided,* That

a. if the dividend is to be paid in shares having a par value, the aggregate par value of such shares shall not exceed the amount of that portion of the corporation's surplus which is tranferred to capital as payment for such shares;

b. if the dividend is paid in shares having no par value, the number of such shares may be fixed by the board of directors;

c. no dividend payable in shares of any class shall be paid to shareholders of any other class unless the articles so provide or such payment is authorized by the vote of the holders of a majority of the shares of the class in which the payment is to be made.

7. A corporation which owns wasting assets intended for sale in the ordinary course of business, such as mines, or oil or gas wells, or timber, or a corporation which owns property having a limited life, such as a lease for a term of years, or patents, need not deduct the depletion of such assets by sale or lapse of time in the computation of the fund available for dividends, and such a corporation may pay dividends from the net profits arising from its business without deduction of such depletion, subject, however, to the rights of the shareholders of different classes. [L. '33, p. 785, § 24]

§ 3803-25. *Unlawful dividends.*—If any dividend be paid in violation of section 3803-24, or if any other unlawful distribution, payment or return of assets be made to shareholders.

1. The directors who knowingly, or without making reasonable inquiry, voted in favor thereof shall be jointly

and severally liable to the corporation in an amount equal to the amount of the dividend so paid and the distribution, payment or return of assets so made;

2. Every shareholder who received any such dividend or any such distribution, payment or return of assets shall in the following instances be individually liable to the corporation in an amount equal to the amount so received by him:

a. when no director is liable to the corporation as provided in subdivision 1 of this section, or

b. to the extent that the corporation is unable to obtain satisfaction after judgments recovered against directors upon the liability imposed by subdivision 1 of this section.

3. No action shall be brought against a director, under subdivision 1, or against a shareholder under subdivision 2

a. unless brought within two years from the date on which such payment, distribution or return was made; and no action shall be brought against a shareholder, under subdivision 2

b. unless brought within two years from the date of final judgment against the directors. [L. '33, p. 787, § 25.]

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 14-1. *Surtax on undistributed profits of corporations.*—In general, the Act imposes a surtax on the net income of corporations in an amount measured by the undistributed net income. The rates of surtax are graduated in brackets, the lowest rate being 7 percent of that portion of the undistributed net income not in excess of 10 percent of the adjusted net income and the highest rate being 27 percent of that portion of the undistributed net income which is in excess of 60 percent of the adjusted net income.

* * * * * * * *

The undistributed net income is defined in section 14 (a) (2) as the adjusted net income minus the sum of (*a*) the dividends paid credit provided in section 27 (see ar-

ticles 27 (a)-1 to 27 (h)-1, inclusive), and (*b*) the credit provided in section 26 (c), relating to contracts restricting the payment of dividends (see article 26-2).

* * * * * * * *

ART. 26-2. *Credit in connection with contracts restricting payment of dividends.*—(*a*) The credit provided in section 26 (c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. The charter of the corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c). The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

If a corporation is restricted with respect to the payment of dividends by two or more contract provisions coming within section 26 (c) (1), only the largest of the credits computed with respect to each of such provisions, and not their sum, shall be allowable under section 26 (c) (1) and, for such purpose, if two or more credits are equal in amount, only one shall be taken into account. However, section 26 (c) (3) provides that if both section 26 (c) (1) and section 26 (c) (2) apply, only the one of such paragraphs which allows the greater credit shall be applied, and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

(*b*) *Prohibition on payment of dividends.*— The credit provided in section 26 (c) (1) is allowable only with respect to a written contract executed by the corporation prior to May 1, 1936, which expressly deals with the payment of dividends and operates as a legal restric-

tion upon the corporation as to the amounts which it can distribute within the taxable year as dividends. If an amount can be distributed within the taxable year as a dividend—

(1) in one form (as, for example, in stock or bonds of the corporation) without violating the provisions of a contract, but cannot be distributed within the taxable year as a dividend in another form (as, for example, in cash) without violating such provisions, or

(2) at one time (as, for example, during the last half of the taxable year) without violating the provisions of a contract, but cannot be distributed as a dividend at another time within the taxable year (as, for example, during the first half of the taxable year) without violating such provision—there the amount is one which, under section 26 (c) (1), can be distributed within the taxable year as a dividend without violating such provisions.

The credit provided in section 26 (c) (1) is equal to the excess of the adjusted net income, as defined in section 14 (a), over the aggregate of the amounts which can be distributed within the taxable year without violating the provisions of such contract. The requirement that the provisions of the contract expressly deal with the payment of dividends is not met in case (1) a corporation is merely required to set aside periodically a sum to retire its bonds, or (2) the contract merely provides that while its bonds are outstanding the current assets shall not be reduced below a specified amount.

* * * * * * * * *

(c) *Disposition of profits of taxable year.*—Under the provisions of section 26 (c) (2), a corporation is allowed a credit in an amount equal to that portion of the earnings and profits of the taxable year which, by the terms of a written contract executed by the corporation prior to May 1, 1936, and expressly dealing with the disposition of the earnings and profits of the taxable year, it is required within the taxable year to pay in, or irrevocably to set aside for, the discharge of a debt incurred on or before April 30, 1936. The credit is limited to that amount which is actually so paid or irrevocably

set aside during the taxable year pursuant to the requirements of such a contract.

Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable year shall be recognized as a basis for the credit provided in section 26 (c) (2). A corporation having outstanding bonds is not entitled to a credit under a provision merely requiring it, for example, (1) to retire annually a certain percentage or amount of such bonds, (2) to maintain a sinking fund sufficient to retire all or a certain percentage of such bonds, by maturity, (3) to pay into a sinking fund for the retirement of such bonds a specified amount per thousand feet of timber cut or per ton of coal mined, or (4) to pay into a sinking fund for the retirement of such bonds an amount equal to a certain percentage of gross sales or gross income. Such provisions do not expressly deal with the disposition of earnings and profits of the taxable year. A contractual provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of "net income," "net earnings," or "net profits."

The term "debt" as used in section 26 (c) (2) does not include an obligation of the corporation to a shareholder, as such, as distinguished from a creditor. Accordingly, amounts paid into, or set aside for, a sinking fund by a corporation for the retirement of preferred stock, pursuant to the terms of an agreement underlying the preferred stock issue, shall not be considered as set aside for discharge of a debt. An indebtedness evidenced by bonds or other similar obligations issued by a corporation is incurred as of the date such obligations are issued, and the amount of such indebtedness is the amount represented by the face value of the obligations. For the purpose of this article a bond or other similar obligation is not issued until it is executed and delivered to a person who holds it as a debt of the corporation. Bonds issued after April 30, 1936, in exchange in refunding a preexisting issue represent debts incurred after April 30, 1936, within the meaning of section 26 (c) (2).

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

No. 9207

NORTHWEST STEEL ROLLING MILLS, INC., *Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

REPLY BRIEF OF PETITIONER.

REPLY BRIEF OF PETITIONER.

Upon Petition to Review a Decision of the United States Board of Tax Appeals.

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It is conceded, as stated in respondent's brief, that this court has jurisdiction pursuant to §§1141-1142 of the Internal Revenue Code. We shall reply to respondent's arguments in the order in which respondent has presented them.

I.

Could Dividends Have Been Paid Legally During the Taxable Year 1936?

There is no dispute in the evidence that from January 2, 1934, when Harry Goetz became manager of petitioner (R. 49), the company had *never* been in a position to pay a dividend (R. 50). Nor is there any dispute that a deficit had accumulated from January 2, 1934 (R. 50). This evidence was admitted without objection. Respondent now argues, for the first time, that the testimony of Harry Goetz is a "conclusion."

If we assume that it was a "conclusion," nevertheless,

having been admitted without objection, and being undisputed, its constitutes proof of the fact.

"In approaching the questions presented for our decision, we have in mind the elementary rule that issuable facts need not be shown by direct evidence, but may be arrived at by fair inference. We have in mind also the rule that parties have a right to try their case on evidence which is not of the quality and character required by the law, and where such evidence is admitted without objection, it is the right and duty of the court to give it the same consideration as if it were legal evidence." *Schanbacher, et al.*, v. *Lucido Bros.*, 93 S. W. (2d) (Mo.) 1076, 1081.

"Agency of this case is a question of law to be determined by the court upon the primary facts, and such facts only should have been elicited from the witness upon this point, and the answer of the witness states a legal conclusion and was incompetent. *Ford Motor Co.* v. *Levesay*, 61 Okl. 231, 161 Pac. 901. This evidence was admitted however without objection and stands without any effort of the plaintiff to strike it from the records. When incompetent evidence is thus admitted it must be given its natural effect. This evidence therefore is sufficient to make a prima facie proof of agency * * *." *Stanley* v. *Wilkinson*, 229 Pac. (Okla.) 574, 576.

The following cases also support the proposition that even assuming a witness testifies to a conclusion, if such testimony is admitted without objection, it is of probative value.

Spicer, et al., v. *Henderson*, 43 S. W. (Texas) 27;
Sugerman, et al., v. *Stelling, et al.*, 135 N. Y. Supp. 595;
Ridenhour v. *Okla. Contracting Co.*, 45 S. W. (2d-Mo.) 108, 112;
Maine v. *May Stern Furniture Co.*, 21 S. W. (2d-Mo.) 211, 213;
Wood v. *Consolidated School Dist. No.* 13, 7 S. W. (2d-Mo.) 1018, 1021.

"Parties have a right to try their case on evidence which is not of the quality or character required by law,

and where such evidence is admitted without objection, it is the right and duty of the court or jury to give it the same consideration as if it were legal evidence." 23 C. J. 39, §1783, "Evidence."

Consequently, assuming which we do not concede, that the testimony of Mr. Goetz is only a conclusion, still it went in without objection and no attack was made upon it in the record. It was uncontroverted.

The Board treated the question of the Charter and its effect as one of law only (R. 17). Had the Board refused to accept the testimony referred to, and which was uncontroverted, such refusal would have been error.

> "Since no evidence whatever was submitted for respondent, it was error wholly to ignore this testimony." *Belridge Oil Co.* v. *Commr.*, (C. C. A.-9) 85 Fed. (2d) 762, 768.

The question for decision is whether the charter and laws constitute a written contract within the statute allowing a credit, there being no controverting evidence that a dividend could not have been paid. In the light of the foregoing, the Board was not called upon to make a finding on matters of fact not in dispute. If such a finding had been necessary, the proper course would be to remand for that purpose.

> *Eaton* v. *Commr.*, 81 Fed. (2d) 332 (C. C. A.-9);
> *Anderson* v. *Commr.*, 78 Fed. (2d) 636, 638 (C. C. A.-9);
> *Belridge Oil Co.* v. *Commr.*, 85 Fed. (2d) 762 (C. C. A. 9).

Respondent refers to surplus by *appraisal.* The Corporation Act of the State of Washington specifically provides that the Board of Directors

> "Shall determine and make proper allowance for depreciation and depletions sustained and losses of every character. Deferred assets and prepaid expenses shall be

written off, as least annually in proportion to their use as may be determined by the Board of Directors."

Uniform Business Corporation Act, Laws of 1933, p. 785, §24, State of Washington;
Rem. Rev. Stat. 3803-24 (3).

Surplus by appraisal does not indicate a real surplus for dividend purposes. Furthermore, under the decisions in the State of Washington, which decisions constitute corporate law which is part of the contract between the corporation, the state and the stockholders, the corporation could only pay dividends out of profits and it is stipulated that there was an operating deficit at the end of 1935 of $76,983.26 (R. 71). The income for 1936 did not equal the amount of said deficit (R. 71).

Respondent cites *Goodnow* v. *American Writing Paper Co.*, 73 N. J. Eq. 692, 69 Atl. 1014, and contends that a dividend may be declared out of profits even though the total assets of the company may not exceed its debts and the nominal share capital. However, under the New Jersey Act, considered in that case, it was provided that the directors of a corporation shall not make dividends, except from its surplus, *or from net profits* arising from the business of such corporation. The court stated:

> "Although the change in language indicates that the Legislature made a distinction between surplus and net profits, it does not necessarily follow that net profits mean the difference between gross earnings and what may be called operating expenses. Such profits may be called annual profits, *and it may be that by net profits the Legislature meant the net profits upon the whole of the company's business from its organization.*"

Respondent cites *New Colonial Ice Co.* v. *Helvering*, 292 U. S. 435, wherein it is said that a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms, and to *Welch* v. *Helvering*, 290 U. S. 111, wherein it is said that the Commissioner's ruling has the presumption of correctness and the petitioner has the burden of proving it to be wrong. There is another familiar rule,

however, stated in *Belridge Oil Co.* v. *Commr.*, (C. C. A. 9) 85 F. (2d) 762, as follows:

> "Where it appears * * * that the methods pursued were erroneous, the presumption that the determination of the Commissioner was prima facie correct no longer avails." *pp. 768, 769.*

And further, it is said in the same case:

> "The presumption that the determination of the Commissioner was prima facie correct no longer avails, where it appears, as in this record, it does appear, that the evidence overcomes such presumption." *p. 769.*

In the instant record, the evidence is undisputed that a dividend could not have been paid. If the charter and state laws constitute a contract within the meaning of §26 C, then obviously the method employed by the Commissioner is erroneous and any presumption of correctness would be overcome.

II.

Charter Is a Written Contract Within the Meaning of Section 26, C, Revenue Act of 1936.

Respondent relies upon *Crane Johnson Co.* v. *Commr.*, 105 F. (2d) 740 (Adv. Sh. No. 3) (C. C. A. 8). A petition for rehearing has been filed in that case. The decision is based upon the North Dakota statute which provides that:

> "The *directors* of corporations must not make dividends except from the surplus profits arising from the business thereof; nor must they divide, withdraw, or pay to the stockholders, or any of them, any part of the capital stock. * * *" §4543, North Dakota Compiled Laws of 1913.

Section 4544 imposes liability upon the directors for improper dividends in event of dissolution of the corporation. The court stated:

> "For some purposes, the charter of a corporation may be said to be a contract with the state, and the laws, constitutional or statutory, of the state where the corporation is organized *become a part of its articles of incorporation,*

so that the charter of a corporation organized under general law consists of its articles of incorporation *and the laws applicable thereto.* Here the articles of incorporation and such certificate as may have issued on the organization of the corporation contain no provision restricting dividend payments. It is necessary, therefore, to look to the statutes of North Dakota for the restriction, and to determine whether the state law of North Dakota is a written contract *executed by the corporation.*" (p. 743.)

The court then observes that §4543 contains a prohibition against improper declaration of dividend *by directors,* and that §4544 penalizes the directors under certain conditions.

"The obligation is that of the directors, and in the event of the improper exercise of their power to declare dividends, they, *as distinguished from the corporation,* may be held liable for the consequences of a violation of the statute. Under the North Dakota statutes the liability is statutory *and is purely one between the directors and the creditors. The corporation itself has made no written contract affecting its right to declare dividends.*" (p. 743.) (Italics ours.)

Basing its opinion upon the North Dakota statute, the court proceeds upon the premise that since the statute only relates to rights between the directors and the creditors, it does not constitute a prohibition against the corporation itself.

The statute in the State of Washington, however, is a direct prohibition *against the corporation.* It states:

"*No corporation* shall pay dividends, * * *" Rem. Rev. Stat. 3803-24 (4).

Furthermore, the section captioned "Unlawful Dividends" (Rem. Rev. Stat. 3803-25) not only provides for remedies against directors who knowingly or without making reasonable inquiry vote in favor of the illegal dividend, but also provides for a remedy *by the corporation* against shareholders who receive any such dividends. The liability of the director and of the shareholder respectively is *to the corporation.* Thus instead of being an obligation between directors and creditors alone, the corporation is the party protected by the

statute and is likewise the party prohibited from making the payment of dividends under certain circumstances.

Consequently, if we accept the *Crane Johnson* decision as law and apply it to corporations in the State of Washington, we reach the result that the charter of the corporation consists of the Articles of Incorporation and the laws applicable thereto, and that in the State of Washington there is a provision expressly dealing with dividends, prohibiting the *corporation* from making such payment under conditions such as existed here.

The Eighth Circuit held in *Jones* v. *Mo. Edison Elec. Co.*, 144 Fed. 765, at 770:

> "The relation of a stockholder to his corporation, to his officers and to his co-stockholders is one of contract and of confidence. By the acceptance of his shares of stock, he agrees to assume the liabilities and discharge the duties imposed upon a stockholder by the law. The statutes, the charter, and the by laws of the corporation, *as well as the settled law of the land at the time he takes his stock, are read into, and become a part of his agreement.* The provision of the statutes of Missouri that a manufacturing corporation might be consolidated with another corporation whose objects and business were of the same nature, upon the consent of three-fifths of the owners of its stock, was a *part of the agreement* of the complainant and a consolidation made by the officers and the owners of the requisite amount of the stock of his corporation, by the faithful exercise of the powers thus granted was neither void in itself nor voidable at his option, because it was but *the performance of the agreement which he made with them.* • • •"

By the same token, the contract between the stockholders, the state, and the corporation in the intant case expressly provided against the payment of dividends *by the corporation* under certain circumstances. This contract was in writing. The articles of incorporation and the certificate were written, and by the decisions cited, the laws of the state and the state statutes "are read into" and become "a part of" that "agreement." Distinguished from the North Dakota statute, the Washington statute places the prohibition directly upon the

corporation, and by accepting the charter and issuing stock, the corporation necessarily agrees that *it* will not distribute dividends under certain conditions.

We submit that the *Crane Johnson* opinion must be considered in the light of the North Dakota statute which it interpreted, which statute is distinctly different from the Washington statute in that the relation in North Dakota is between the creditor and the directors, whereas under the Washington State statute the prohibition is directly and expressly against the corporation. Therefore, the premise from which the court proceeds to a conclusion in the North Dakota case does not exist under the law of the State of Washington.

Assuming, however, that the two state statutes were identical, we then submit that the *Crane Johnson* decision should not be followed by this court, for the following reasons:

(1) The decision is in error in holding that section 26 (c) (1) is a credit provision to be strictly construed. On the contrary, it is a relief provision which should be construed liberally. The rule of construction is that a relief provision is to be liberally construed to afford the relief it was intended to provide.

Helvering v. *Bliss*, 293 U. S. 144, 151;
Kelly Springfield Tire Co. v. *U. S.*, 81 F. (2d) 533, 535 (C. C. A.-3);
Cochran v. *Commr.*, 78 F. (2d) 176, 179 (C. C. A.-4);
In re Johnston, 33 B. T. A. 551, 553.

We further note with interest the quotation in respondent's brief from the Senate report, No. 2156, 74th Congress, 2d Session, pp. 12-13, 15, in which, relative to Section 26, it is stated:

> "Contracts not to pay dividends: This credit is in principle *similar to a relief provision* allowed in the House Bill for the purpose of the undistributed profits tax imposed by that bill."

This clearly indicates an intention that the section should be construed liberally as a relief provision.

Even if we were to assume that this provision was in the nature of an exemption, still it would not be strictly construed against the taxpayer.

In *U. S.* v. *Merchants Natl. Trust & Savings Bank*, 101 F. (2d) 399 (C. C. A. 9), decided this year, it is stated:

> "We are conscious of a former principle in construing exemptions in a taxing act of transactions otherwise taxable as here, where the shares are transferred by operation of law, that ambiguities must be construed against the taxpayer. * * * We take it that this has been overruled and that the court is now to exercise the function of 'resolving doubts' in construing all tax legislation."

Secondly, the court overlooked the fact that a stock certificate issued to a shareholder constitutes a written contract, into which the written provisions of the state law are read as if fully set out therein. *In re Culbertsons*, 54 F. (2d) 753 757 (C. C. A. 9). This court stated in that case:

> "This statutory condition imposed upon the right or privilege of calling in or redeeming preferred stock although not expressed in the retirement provisions of any of the certificates here involved, is upon a familiar legal principle to be read into those provisions."

See also:

Hammond & Co. v. *Hastings*, 134 U. S. 401.

With respect to War Risk insurance policies the Supreme Court stated:

> "The terms of these contracts are to be found in part in the policy and *in part in the statutes* under which they are issued and the regulations promulgated thereunder." *Lynch* v. *U. S.*, 292 U. S. 571, 577.

The instant contract was executed by the corporation and a provision thereof (the statute) made as clearly a part of the agreement as if it had been stated therein, expressly deals with the payment of dividends. Had that provision been written as a paragraph of the articles of incorporation, obviously it would conform to the requirements of 26 (c) (1). There is no real difference between making it a part of the contract by a written paragraph therein, and making it a part of the contract by operation of law. It is as binding in the one instance as in the other and all that the statute here in question requires is

that the provision "expressly deals" with the payment of dividends.

Respondent refers to legislative history of the act. Unless words of a statute are ambiguous, no resort may be had to legislative history.

Helvering v. *City Bank Farmers Trust Co.*, 296 U. S. 85, 89;

Minnesota Tea Co. v. *Commr.*, 76 Fed. (2d) 797 (C. C. A.-8).

We notice at page 12 of respondent's brief an argument based upon the legislative history of the act, which implies that the Act is ambiguous. Yet, at page 21 of respondent's brief, it is insisted that the taxpayer is not entitled to the benefits of the usual principle that in case of doubt the statute will be construed in favor of the taxpayer, because as respondent argues, this act is "plain" in its meaning when applied to the facts in the instant case. Thus respondent resorts to legislative history notwithstanding that it is well settled that, unless there is ambiguity, the legislative history has no part in the court's consideration of the statute, but argues against resolving the construction of the statute in favor of the taxpayer because the statute is "plain."

So far as the legislative history is concerned, it is not particularly helpful because the reports of both the Senate and House committees and the discussion on the floor of the House and Senate were addressed to a different bill than that which finally emerged from the conference committee which met subsequent to those reports and discussions.

> "The House and Senate 1936 bills were dissimilar in general aim, theory, and in structure. The 1936 Act as finally enacted was to a considerable extent written in conference without any new statement of legislative intent —a fact which contributes in no small measure to the difficulty of interpretation of the Act." *Paul & Mertens*, "Law of Federal Taxation," 1938 Cum. Supp., Vol. 3, ¶32A.05.

The reference to Senator W[illegible] statement has no importance because he was not in ch[illegible] of the bill and his state-

ment could not be considered even if it were permissible to resort to legislative history.

See:

Duplex Printing Press Co. v. *Deering*, 254 U. S. 443, 474;

Lapina v. *Williams*, 232 U. S. 78, 90;

U. S. v. *Trans Missouri Freight Assoc.*, 166 U. S. 290, 318.

We shall note a portion of respondent's argument under this heading in a subsequent portion of this brief.

The legislative history does not aid because the discussions were relative to a different bill and we do not have the benefit of the reasons for changes made in the committee. It may well be that the lawyers on the Committee realized that in the light of the well known principle of law that a charter is a contract and that the state law is part of the charter, such contract would come within Section 26 (c) (1). If the discussions indicate anything, it is that 26 (c) is a relief provision; thus it is to be liberally construed.

III.

Is the Act Unconstitutional?

Respondent states:

> "Clearly Congress did not intend that the right to the credit should depend upon or vary in accordance with state laws. * * * There is no expression or implication in Section 26 (c) (1) which would require allowance of the credit in one state and disallowance in another, depending upon their peculiar laws respecting dividend payments. On the other hand, Congress clearly had in mind and intended to establish a uniform rule which would operate *without regard to state laws.*" (R. Br., pp. 20, 21.)

Thus respondent concedes that Congress intended not to respect the provisions of law of the several states with respect to the management of corporations.

> "Incidental regulation of such practice by Congress through a taxing act can not extend to matters plainly

inappropriate and unnecessary to reasonable enforcement of a revenue measure. * * *" *Linder* v. *U. S.*, 69 Law. ed. 819, 823, 268 U. S. 5, 17.

It is the law of Washington that dividends paid in impairment of capital are illegal. *Sparling, Trustee* v. *General Discount & Mtge. Corp.*, 178 Wash. 663, 670, 35 P. (2d) 60. Thus Congress would tax a corporation because it did not perform an illegal act. This is a matter plainly inappropriate and unnecessary to reasonable enforcement of a revenue measure. The cases cited by respondent are to the point that "Congress in raising revenue has incidental power to defeat obstructions to that incidence of taxes which it chooses to impose," but this is far from holding that Congress has the power to regulate the corporations of the various states so that they must either commit an illegal act under state law or submit themselves to a heavy Federal tax. Respondent relies on *Helvering* v. *Nat. Grocery Co.*, 304 U. S. 282, and *Willcutts* v. *Milton Dairy Co.*, 275 U. S. 215, 220. In the former case, the federal taxing provision imposed a tax upon net income of a corporation used for the purpose of evading imposition of surtax on its shareholders—quite a different principle than taxing a corporation because that corporation refuses to commit an illegal act. In the *Milton Dairy* case, it is held that tax on net income is proper though there is an impairment of capital, but no reference is made to State law. In *United Business Corp.* v. *Commissioner*, 62 F. (2d) 754 (C. C. A. 2), a corporation was being used to avoid taxes. This was also the case in *Armour Securities Co.* v. *Comm'r*, 91 F. (2d) 427 (C. C. A. 5).

Plainly a line against regulation must be drawn somewhere, and it is simply absurd to argue that the Federal Government is not in effect regulating corporations when it imposes an onerous tax based upon inability of the corporation under the State law to pay a dividend.

Respondent attempts to justify this by stating that Congress may pass measures reasonably calculated to prevent avoidance of tax. Wherein is there an attempt to prevent an avoidance of taxes when the Federal officers are conclusively presumed to know what the state laws are?

Respondent, when arguing as to the distinction between oral and written contracts, says (page 28 of his brief):

> "It is a comparatively easy matter for the Bureau of Internal Revenue to ascertain whether an ordinary written contract prohibits payment of dividends."

If this is true, why it is not a comparatively easy matter also for the bureau to determine whether or not the law of a particular state prohibits the payment of dividends? It is submitted that the argument of reasonableness of the regulation is wholly wanting in force and that the act constitutes an invasion of the state powers of regulation of its corporations and if carried to its logical ends would destroy that state power.

Respondent refers to our argument that the tax constitutes a penalty. As stated in our opening brief, the tax is not on income at all, but is dependent upon what the taxpayer does with its income already taxed. The undistributed profits tax in reality is not an income tax, nor is it an excise tax, for it arises only as a condition of what the taxpayer does with income already taxed. See:

Eisner v. *Macomber*, 64 Law. ed. 521, 252 U. S. 189.

With respect to the distinction drawn between written and oral contracts, respondent argues that since deductions are discretionary, appellant can not complain. However, assuming deductions are discretionary, still a tax must be within constitutional limits. Respondent argues that the distinction is upon a rational basis because of the added difficulty of determining the validity and scope of oral contracts. This argument is used by respondent, however, in connection with charter provisions and state laws. Yet, state law must be given consideration by internal revenue officials in many instances, as illustrated in *Lang* v. *Comm'r*, 204 U. S. 264, and *Blair* v. *Comm'r*, 300 U. S. 5.

It is no more difficult for Federal departments to ascertain the state law applicable to a particular contract than it is for a taxpayer to ascertain the Federal law, and the taxpayer is confronted with treasury rulings in many instances directly contrary to court decisions. We have noted no disposition on

the part of the Treasury Department to evince sympathy for the taxpayer because of the maze of regulations which that Department issues or to contend that because of the difficulties involved the regulations are unreasonable.

It is argued by respondent that practical considerations must prevail. It is clear, however, that by "practical considerations," respondent is thinking of but one thing—claimed difficulty of enforcement. The Constitution should not bend to legislation because that legislation eases the burden of the taxing official though it is impossible for the taxpayer legally to make the distribution which the taxing act was designed to cause taxpayer to pay out. If practical considerations are to be weighed, why not consider the taxpayer's dilemma? The State says to taxpayer: "Don't distribute dividends." The Federal Government says: "If you don't, we tax you;" and "We're taxing you, not because you made so much money, but because you are not distributing it, although we know you can't do so because the State prohibits you from doing that."

Conclusion.

The proof of inability to pay the dividend is in the record without objection and respondent can not now complain on that score. To raise that question at this late date is an acknowledgment of weakness as to the other points.

The charter is a written contract and a part of that contract is the state law. A provision of the state law expressly deals with dividends and is as much a part of the charter of the corporation as if it had been written word for word in that charter. Consideration of the legislative history is both unnecessary and lacking in helpfulness. If there is any doubt as to interpretation of the section, that doubt should under well established principle, be resolved in favor of the taxpayer, particularly since this relief provision is to be liberally construed.

If the credit is not given, then the act is unconstitutional, being a wrongful invasion of the power of the states and containing an arbitrary discrimination between written and oral contracts. Furthermore, the so-called "Undistributed Profits

Tax" is in reality nothing more than a penalty, for it is neither excise tax nor income tax, but is dependent upon what the taxpayer does with the income already taxed.

For the reasons stated, no deficiency should be assessed against petitioner.

Respectfully submitted,

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EXHIBIT "D."

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TAXATION AND THE FALL OF THE ROMAN EMPIRE

By ARTHUR E. R. BOAK*

To students of the history of civilization, the fall of the Roman Empire and the accompanying cultural decline of the Mediterranean World has long presented, and still continues to present, a problem of unique fascination. Thirty years ago, however, it would have been rash to assert that in this country at least there was any widespread interest even in educated and intelligent circles in a question which apparently had so little to do with the world in which we then lived. An all pervading belief in the doctrine of continuous progress and a sublime confidence in the solidity of the foundations of modern society had produced a certain indifference, tinged with contempt, towards peoples of the past who had not been able to solve the problems of their own time or preserve their states and their civilization. But today the situation is different. The universal economic and political confusion which has prevailed since the World War and the realization that another conflict of this type might produce a collapse of European civilization have undermined the general faith in the stability of our own social structure. As is only natural, this attitude of mind has caused thoughtful people to scan more closely the past experi-

*Professor Arthur E. R. Boak in his discussion of *Taxation and the Fall of the Roman Empire* makes no comparisons. Nevertheless, as Chairman of the Department of History in the University and an authority on the governmental institutions of the Roman Empire, he sets down some facts which have a certain significance today. This article formed Professor Boak's presidential address at the meeting of the Michigan Academy of Science, Arts, and Letters in Ann Arbor, March 17. In the preparation of this paper Professor Boak wishes to acknowledge the helpful suggestions of Professor Max Handman, of the Department of Economics.

ence of the human race to see where similar crises have occurred and from what conditions they have arisen.

Doubtless many are familiar with various theories which have been advanced to account for the decline of the Roman Empire. They include waning morality, Christianity, soil exhaustion, decrease in population, inadequate methods of production and distribution, and the extermination of the abler elements as a result of war and political persecution. There is no doubt that some of these played a part, perhaps a large one, in the general picture. I must emphasize, however, that today no serious student of the period believes that the fall of Rome, which involved the collapse of ancient civilization, can be explained in terms of one single cause. It is also unanimously agreed that the breakdown came from within rather than from without; in other words, it was not the increasing power of the barbarians but the declining power of the Roman world which made possible the penetration and occupation of the western part of the Empire by the Germanic peoples from central and northern Europe. In attempting to explain the growing weakness of the Roman state, it seems to me that historians have not stressed sufficiently the part played by the increasing cost of government or, to state it somewhat differently, the increasing burden of taxation.

In the first and second centuries after Christ the Roman Empire enjoyed its greatest prosperity. It stretched from Scotland to the Arabian Desert, and from the Sahara to the basins of the Rhine and the Danube. Its area was about 3,500,000, square miles; its population between 50,000,000 and 60,000,000. For governmental purposes, the Empire was divided into a number of large districts called provinces, and these in turn were subdivided into smaller units, usually organized as municipalities with local autonomy. Local government constituted a charge upon the local property holders. Municipal offices were unsalaried and were open only to those who had a definite property qualification. If a sufficient number of qualified candidates did not present themselves at the annual election, candidates could be drafted from the qualified class. Ex-magistrates became town councillors for life without salary. In Egypt, prior to the introduction of the municipal system

in the third century, local officials were appointed from the propertied class by the provincial authorities.

Thus the effective maintenance of local government constituted an indirect tax upon property. Provincial government was conducted by a governor and a group of subordinate officials sent from Rome to administer justice and collect the taxes imposed by the imperial government. At Rome itself existed a number of central administrative bureaus which controlled the activities of the provincial administration. This superstructure of provincial and imperial government was supported by taxation, levied largely upon the provinces and collected by imperial or local agents in the municipal or other local administrative units. We do not need to concern ourselves greatly with the individual taxes, except to say that they included most of the forms which are familiar to us—property taxes, poll taxes, sales taxes, inheritance taxes, and tariffs. *But one aspect of Roman imperial finance differed markedly from that of modern governments; namely, that no system of floating government loans by bond issues was known.* Thus extraordinary expenses must be met by direct levies and *the burden could not be passed on to coming generations.* On the other hand, the Roman government could requisition on its own terms both supplies and services from the people of the Empire, over and above the normal load of taxation. Such requisitions must be regarded as a special form of taxation.

In the period under consideration, that known as the Principate, the Roman government had definitely abandoned the policy of exploiting the provinces for the benefit of the governing classes and moneyed interests of Rome, which had prevailed under the Republic. Although at first Italy occupied a favored position within the Empire, this superiority gradually disappeared. The extension of Roman citizenship to the provincials and the admission of Romans of provincial birth to the imperial aristocracy and the principate itself were outstanding factors in this process of assimilation. The Roman government realized that the prosperity of the Empire depended upon the prosperity of the provinces and strove to promote their economic well-being, fostering in particular the organization of new municipal units and expanding the class

of independent landholders. *Under the aegis of Rome peace prevailed, agriculture flourished, trade and industry expanded, until by the middle of the second century* A.D. *the ancient Mediterranean World reached the height of its material prosperity.*

In the meantime, however, the imperial government *became increasingly autocratic and more and more highly centralized.* The interests of the state completely overshadowed all other interests—provincial, municipal and individual. The preservation of the Empire became the ultimate goal of public policy. At the same time the imperial government extended its functions and increased its administrative machinery, thus laying an increased burden upon the taxpayers which more than counterbalanced the general rise in prosperity. The creation of the imperial government service with its numerous departments and its permanent paid officials; the development of the imperial post; the construction of public works on a generous scale; the elaboration of the system of doles and entertainments for the populace of the capital; the support given to education, public health, and Italian farm relief; and the increase in the military establishment necessitated by problems of frontier defence combined to raise the cost of government far above its figure at the outset of the Principate. So precarious was the financial situation, that a protracted war or a spendthrift emperor threatened to cause, and at times actually did cause, bankruptcy of the treasury.

We have many bits of evidence to show that the cost of the government of the Empire strained the taxpaying power of its populace. Lack of m o n e y was one of the reasons for abandoning the attempt to secure the northern frontier by occupying the region between the Rhine and Elbe, and for surrendering to the Arthians the eastern conquests of Trajan in Armenia and Mesopotamia. The burden of taxation played a part in causing the rebellion in Judaea in A. D. 66. At his accession the emperor Hadrian found arrears of taxation going back over fifteen years and thought it advisable to remit these. But the same emperor added to the imperial service the numerous advocates of the fiscus whose duty it was to prosecute the claims of the treasury a g a i n s t delinquents. Marcus Aurelius, whose principate followed the peaceful period of Antoninus Pius, had to follow Hadrain's example in

remitting arrears of taxation and had to meet repeated requests from the municipalities for financial support or for reduction of tax quotas. The same emperor expressed with brutal frankness the desperate condition of the public finances when he answered the petition of his victorious troops for an increase in pay with the words: "Anything you receive in excess of your regular stipends must be exacted from the blood of your parents and relatives."

It is from Egypt, however, that we derive our clearest evidence of the cost of imperial government to the individual provinces. Although Egypt was exploited more thoroughly for the benefit of the imperial treasury than the other provinces of the empire, it was by no means the intention of the government to ruin its people (as Tiberius put it, the governor should "shear the sheep, not flay them"), but rather to cause them to prosper so that they could produce more revenue. Hence, if taxation proved too heavy, it meant that the combined weight of local and imperial administration was greater than even this rich area could support. Already by the middle of the first centrury A.D. serious complaints of fiscal oppression appeared. The Roman administration was as strict with the tax collectors as with the taxpayers. It required the former to offer their properties as security for the sum total of taxes which they were to collect. Hence the tax officers employed every means in their power, legal or illegal, to force the individual taxpayers to contribute the full amount for which they were liable. If a person lacked the means to meet his quota, his relatives or even his fellow townsmen and villagers were forced to make good the deficit. The demands of the collectors were enforced with brutal violence and at times soldiers were called upon to coerce those who failed to meet them. In times of poor harvests, farmers who could not pay their taxes took to flight, leaving their lands untilled for the next season. Between the years A.D. 55 and 60 the collectors of the poll tax in a group of villages in the Fayum reported that their population, "once numerous," had shrunk to a few individuals as many had absconded owing to their lack of means to meet the taxes and others had died leaving no relatives (P. Graux 2). At about the same time, in another village of the same area, over forty propertyless run-aways were reported for two successive years as being in arrears with poll and dyke

taxes, and in the second year fifty-four others as having left for parts unknown to avoid their public obligations (P. Cornell 24, and P. Ryl. Inv. no. 823; H. I. Bell, "The Economic Crisis in Egypt under Nero," *J. R. S.*, 1938, pp. 6-7).

In spite of all attempts of governors and even emperors to curb illegal exactions and to improve the condition of the tillers of the soil, the situation gradually grew worse. The necessities of the government prevented any material alleviation of the tax load. More and more peasants refused to lease public lands because the burdens involved were too heavy, and in order to prevent loss of revenue from this source the government assigned the unleased plots to adjacent villages or private landowners who thereby became responsible for their cultivation and the payment of taxes thereon. This put an even heavier burden on those who remained and the flight of the peasants assumed ever larger proportions, and led to the armed revolts of A.D. 152 and 172.

But it was not only the tenant farmers who suffered under this system. Landowners and townsmen were affected also. At first the Romans had employed salaried officials in the administration of Egypt, following the custom of their predecessors, the Ptolemies. But in the latter part of the first century A.D. they resorted to the practice of drafting the officials from the propertied classes of the towns and villages. These appointees served without salary, and such service constituted an additional tax upon their properties. In resorting to this method of recruiting their administrative and police personnel, the Romans were not altogether innovators. Rather, they seized upon the well-known Greek institution of *liturgies* or obligatory public services imposed upon well-to-do persons, but applied it on a scale unexampled hitherto. As the office-holders were responsible with their properties for any deficits in the collections which they had to make, they were merciless in exacting full payment from the helpless peasants. But when the latter took refuge in flight, the burden fell back upon the officials. How frequently flight from the land or confiscation and sale of property to meet fiscal obligations occurred in Egypt during the second century A.D. may be judged from the fact that two of the stock questions addressed to the gods by those who sought heavenly guidance in their mundane af-

fairs were: (1) Shall I run away? and (2) Am I going to be sold out? (V. Martin, *La fiscalité romaine en Egypte*, p. 28.)

In the other provinces of the Empire, we can trace the growing burden of government demands in the increasing resort to requisitons and special levies on the one hand, and on the other in the growth of the principle of personal responsibility on the part of municipal officials for the raising of imperial revenues. By the close of the second century A.D. the holding of municipal offices had become a definite obligation on the part of persons of property. In the eastern cities committees of ten members nominated by the local councils from among the more prosperous citizens, were put in charge of collecting the imperial revenues from their municipal territories. These *dekaprotoi* or 'first ten,' as they were called, became responsible with their properties for any deficiencies in the municipal quotas. The *dekaprotoi* were introduced into Egypt at the beginning of the third century. Here municipal councils were created in the district capitals and charged with the responsibility for the financial administration of the towns and for nominating and acting as sureties for both municipal and state offcials (H. I. Bell, in *C. A. H.* XI, p. 657).

In general, it seems fair to say that by the opening of the third century the cost of conducting both local and imperial government combined with the method of collection had reduced the agricultural population to a precarious situation and had made serious inroads upon the capital wealth of the municipal propertied class which constituted the middle class throughout the Empire as a whole. The resort of the imperial government to systematic and continuous debasement of the coinage from this time onward for over half a century is additional and striking evidence of its inability to meet its expenses by known methods of taxation. When the threefold scourge of civil war, foreign invasion, and plague ravaged the empire between A.D. 235 and 284, the ordinary revenues grew steadily smaller and the emperors were forced to resort to desperate measures to finance their wars and satisfy the demands of the mutinous soldiery. The properties of the supporters of their rivals were confiscated; municipal endowments met the same fate; requisitions of crops, draft animals, other supplies, and personal services were endless.

When comparative peace and order were restored to the Empire by the time of the accession of Diocletian (A. D. 284), the general economic condition was much weaker than it had been at the opening of the third century. Population had declined greatly, large areas had become unproductive owing to lack of agricultural workers and the ravages of war, commerce and industry had sunk to a low ebb, and much capital wealth in the form of buildings, farm animals, etc., had been destroyed. As a result, the taxpaying power of the population was greatly reduced, as in the case of a severe economic depression. Do we find, then, a corresponding attempt to decrease the cost of local and imperial government so as to adjust the tax burden to the capacity of the people to pay? The answer is: "By no means." On the contrary, the military establishment was increased, there was a tremendous expansion of the civil service, and a much more elaborate and costly court ceremonial was adopted. The doles and entertainments provided for the Roman mob were duplicated in the new eastern capital Constantinople. In addition to this, all the old municipal offices with their liturgical obligations were revived and had to be supported as before by the municipal propertied class (C. E. van Sickle, "Diocletian and the Decline of the Roman Municipalities," *J. R. S.*, 28 (1938), pp. 9-18). The principle that the civilian population should toil for the support of the government was definitely accepted and the system of taxation was revised with this end in view.

All farm land was classed as grain land, orchard land, or pasture land. The land of each class was divided into units of approximately equal productive capacity and each unit paid an equal tax in kind at a rate announced by the government in advance for each year. In parts of the Empire, the agricultural workers were also grouped into tax units and paid a poll tax in kind. The other taxes levied upon those engaged in trades and business were collected in money. At the same time, the practice was introduced of paying government employees wholly or partly in allowances of natural products. This step was not taken because of a shortage of precious metals or because of instability of the coinage as has often been assumed. Both the gold and the silver coinage had been put on a sound basis by the monetary reforms of Diocletian and Constantine and they remained stable on this basis until late in the Byzantine Empire. And the bronze coinage, although not so satis-

factory, did not suffer any great fluctuations in value. In private business transactions money economy continued to hold the field against natural economy, and at various times the government showed itself to be possessed of large sums of gold which it expended for purposes of state. The collection of taxes in kind was intended partly to supplant the irregular levies on agricultural produce which had proved such a burden to the producers, and partly to protect the government against loss in case of future inflation or price fluctuation. At the same time, the officials who received salaries in kind were secured against loss through rise in prices and could actually profit when there was a shortage of foodstuffs by selling their surplus receipts at the high market rate. The persons who suffered were the rural taxpayers. If there was an abundant crop and prices were low, they paid their taxes in kind and had to market any surplus at the prevailing low price, but if there was a shortage they could not profit by the current high prices, and in case they were unable to furnish their tax quota in produce they had to make up the deficit in cash at the official market rate.

The adoption of a general land tax in kind completed the ruin of the tenant farmers. Their landlords who must pay the tax insisted on fixed rentals in kind. This system, which took no account of annual variations in crops, led to the tenants becoming indebted to their landlords to such an extent that they abandoned their personal property, threw up their contracts, and left the farms. In answer to the appeals of the landholders who could not pay the property tax if their fields were not tilled, the government intervened and attached the tenants and farm laborers to the estates in the status of serfs. Another consequence of the collection of the taxes and the payment of government employees in kind was the compulsory enrollment of all those who were engaged in the transportation, processing and distribution of these products in hereditary corporations. Under the Principate the government had relied at first upon individual initiative for the handling of government supplies. But as the needs of the state grew and extraordinary requisitions were resorted to with increasing frequency, the government began to draft the services of shipowners and others to cope with the greater volume of produce which required transport by sea and land. To compensate such persons for the loss which they incurred from

their services to the state, they were encouraged to enroll in guilds whose members were granted appreciable privileges and immunities. Under the Autocracy of Diocletian and his successors the further increase in state income in natural products, coupled with the decline in numbers and wealth of the membership of the guilds engaged in shipping and distributing, led the state to take more drastic measures to ensure the performance of public services. The handling of government supplies was made a permanent charge upon capital invested in business of this sort irrespective of transfer of ownership. Finally, when men began to give up such property because of the burdens associated with it, the obligation was made personal as well as real. All those enrolled in the guilds of shippers, millers, bakers, wine, oil and meat dealers and the like, became hereditary members of these corporations, passing on their public responsibilities from one generation to the next (for this interpretation of the economic developments, see in particular G. Mickwitz, *Geld und Wirtschaft im romischen Reiche des vierten Jahrhunderts).*

In the light of what happened to the peasantry and those who were engaged in the transportation and distribution of natural produce, it is not surprising to find that a similar fate overtook the class of proprietors from which the municipal councillors were recruited. Under the new system the councils were nothing more than agencies for the collection of taxes from the municipal territories operating through the municipal officers. The combination of imperial and municipal obligations which weighed upon them proved a crushing load. In order to make sure that the state had these fiscal agents at its disposal all persons who possessed a stated minimum of property automatically became members of their local municipal councils. As in earlier days, the property of the local officials was held as security by the state for any deficit in the amount of the taxes they should collect or other duties they should perform. We can well understand that in their despair over the possibility of meeting the load imposed upon them many abandoned their properties and tried to find a refuge in the army, the civil service or the clergy. Faced with this situation, the state acted as it had done in the case of the peasants and the members of the corporations; it made the town councillors an hereditary class. In their anxiety to meet the de-

mands of the fiscal agents of the state the municipal officers pressed hard upon their own tenants, the tenants of municipal land and others within the municipal tax areas. With this conduct in mind we can appreciate the dictum of a fourth century writer: "Every councillor is a tyrant."

There was one group of persons, however, who defied successfully the demands of local and government tax agents alike. These were the great landed proprietors who formed the highest official class in the Empire and did not hesitate to use their political influence for their economic advantage. They had profited greatly by the imperial policy of encouraging the occupation of uncultivated public lands and now took under their protection, as serfs, the villagers and even town councillors who transferred their lands to them in order to mitigate their tax burdens. Since this form of patronage involved a loss to the state, it was opposed by the emperors to the best of their ability but they had to yield in the end. By the early fifth century, the great proprietors were exempted from the authority of municipal officers and granted the privilege of collecting the taxes themselves on their own great domains.

It was in the fifth century that the fruits of the tax system of the Late Empire were reaped in full. The municipal proprietors as a class had almost completely disappeared. In all the western provinces of the Empire, there was hardly one who had enough property to fulfill the obligations of his order. The imperial post had to be abandoned for lack of persons abie to meet the requisitions for transport animals and vehicles. The peasantry had been reduced to serfdom on state lands or large private estates. These conditions led to a steady decrease in the public revenues, and nothing reveals the low ebb of the state finances more clearly than the great difficulty which the government experienced in raising armies which were mere fractions of the supposed military establishment. Under conditions such as these we can readily understand how the Teutonic tribes, settled at first as Roman allies within the Empire, gradually shook off their allegiance and took over the government of Italy and the western provinces without encountering any serious opposition from the helpless civilian population.

From the foregoing presentation, it should, I believe, be abundantly clear that the system of taxation played a prominent role in the disintegration of the Roman Empire and the economic collapse of ancient society. It violated each of the four canons of taxation laid down by Adam Smith in his famous *Wealth of Nations:* (1) equality in distribution, (2) certainty in amount, (3) convenience in payment, and (4) economy in collection. The Roman taxes, particularly in the Late Empire, may well have been too heavy in themselves, although this is more difficult to prove in view of our ignorance both of the total income of the taxpayers and the total amount levied. However that may have been, under the methods of collection resorted to they proved a crushing burden.

The implications of this transcend a mere interest in analyzing the causes of what we may well regard as the ultimate failure of a great and long-sustained human effort to create and maintain a satisfactory way of living. They point to two general conclusions. One, that in any large state there is grave danger that the combination of local and central government agencies will develop into a load which will outgrow the taxpaying power of the people, particularly if the taxes are assessed and collected in defiance of sound principles of political economy. And, two, that, when the maintenance of any existing form of government takes precedence over the economic interests of those who support it, that government is paving the way for its own undoing.

EXHIBIT "E."

REVENUE ACT 1936
Italics indicate new matter.

Sec. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) DEFINITIONS.—*As used in this title—*

(1) The term "adjusted net income" means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

(C) In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933), the amount allowed as a credit under section 26 (d).

(D) In the case of a national mortgage association created under Title III of the National Housing Act, the amount allowed as a credit under section 26 (e).

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) IMPOSITION OF TAX.—*There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):*

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net

income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

17 per centum of the portion of the undistributed net income which is in excess of 20 per centum and not in excess of 40 per centum of the adjusted net income.

22 per centum of the portion of the undistributed net income which is in excess of 40 per centum and not in excess of 60 per centum of the adjusted net income.

27 per centum of the portion of the undistributed net income which is in excess of 60 per centum of the adjusted net income.

(c) ADJUSTED NET INCOME LESS THAN $50,000.—

(1) SPECIFIC CREDIT.—*If the adjusted net income is less than $50,000, there shall be allowed a specific credit equal to the portion of the undistributed net income which is in excess of 10 per centum of the adjusted net income and not in excess of $5,000, such credit to be applied as provided in paragraph (2).*

(2) APPLICATION OF SPECIFIC CREDIT.—*If the corporation is entitled to a specific credit, the tax shall be equal to the sum of the following:*

(A) A tax computed under subsection (b) upon the amount of the undistributed net income reduced by the amount of the specific credit, plus

(B) 7 per centum of the amount of the specific credit.

(d) EXEMPTION FROM SURTAX.—*The following corporations shall not be subject to the surtax imposed by this section.*

(1) Banks as defined in section 104.

(2) Domestic corporations which for any portion of the taxable years are in bankruptcy under the laws of the United States, or are insolvent and in receivership in any court of the United States or of any State, Territory, or the District of Columbia.

(3) Insurance companies subject to the tax imposed under section 201, 204, or 207.

(4) Foreign corporations.

(5) Corporations which, by reason of deriving a large portion of their gross income from sources within a possession of the United States, are entitled to the benefits of section 251.

(6) Corporations organized under the China Trade Act, 1922.

(7) Joint Stock Land Banks organized under the Federal Farm Loan Act, as amended.

(e) EXEMPT CORPORATIONS. — *For corporations exempt from taxation under this title, see section 101.*

(f) TAX ON PERSONAL HOLDING COMPANIES.—*For surtax on personal holding companies, see section 351.*

(g) IMPROPER ACCUMULATION OF SURPLUS.—*For surtax on corporations which accumulate surplus to avoid surtax on stockholders, see section 102.*

Sec. 26. CREDITS OF *CORPORATIONS.*

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

(a) INTEREST ON OBLIGATIONS OF THE UNITED STATES AND ITS INSTRUMENTALITIES.—*The* amount received as interest upon obligations of the United States or of corporations organized under Act of Congress which is allowed to an individual as a credit for purposes of normal tax by section 25 (a) *(1)* or *(2)*.

(b) DIVIDENDS RECEIVED.—*85 per centum of the amount received as dividends from a domestic corporation which is subject to taxation under this title. The credit allowed by this subsection shall not be allowed in respect of dividends received from a corporation organized under the China Trade Act, 1922, or from a corporation which under section 251 is taxable only on its gross income from sources within the United States by reason of its receiving a large percentage of its gross income from sources within a possession of the United States.*

(c) CONTRACTS RESTRICTING PAYMENT OF DIVIDENDS.—

(1) PROHIBITION ON PAYMENT OF DIVIDENDS.—*An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.*

(2) DISPOSITION OF PROFITS OF TAXABLE YEAR.—*An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.*

(3) DOUBLE CREDIT NOT ALLOWED.—*If both paragraph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.*

(d) BANK AFFILIATES.—*In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933), the amount of the earnings or profits which the Board of Governors of the Federal Reserve System certifies to the Commissioner has been devoted by such affiliate during the taxable year to the acquisition of readily marketable assets other*

than bank stock in compliance with section 5144 of the Revised Statutes. The aggregate of the credits allowable under this subsection for all taxable years shall not exceed the amount required to be devoted under such section 5144 to such purposes.

(e) NATIONAL MORTGAGE ASSOCIATIONS.—*In the case of a national mortgage association created under Title III of the National Housing Act, the amount of the earnings or profits which the Federal Housing Administrator certifies to the Commissioner has been devoted by such association during the taxable year to the acquisition of such reserves as the Administrator may require under the provisions of section 303 of that Act.*

Sec. 27. CORPORATION CREDIT FOR DIVIDENDS PAID.

(a) DIVIDENDS PAID CREDIT IN GENERAL.—*For the purposes of this title, the dividends paid credit shall be the amount of dividends paid during the taxable year.*

(b) DIVIDEND CARRY-OVER.—*In computing the dividends paid credit for any taxable year, if the dividends paid during the taxable year are less than the adjusted net income, there shall be allowed as part of the dividends paid credit, and in the following order:*

(1) Dividends paid during the second preceding taxable year in excess of the adjusted net income for such year, to the extent not needed as a dividends paid credit for the taxable year preceding the taxable year the tax for which is being computed; and

(2) Dividends paid during the first preceding taxable year in excess of the adjusted net income for such year.

No credit shall be allowed for dividends paid by a corporation prior to its first taxable year under this title.

(c) DIVIDENDS IN KIND.—*If a dividend is paid in property other than money (including stock of the corporation if held by the corporation as an investment) the dividends paid credit with respect thereto shall be the adjusted basis of the prop-*

erty in the hands of the corporation at the time of the payment, or the fair market value of the property at the time of the payment, whichever is the lower.

(d) DIVIDENDS IN OBLIGATIONS OF THE CORPORATION.—*If a dividend is paid in obligations of the corporation, the amount of the dividends paid credit with respect thereto shall be the face value of the obligations, or their fair market value at the time of the payment, whichever is the lower. If the fair market value is lower than the face value, then when the obligation is redeemed by the corporation, the excess of the amount for which redeemed over the fair market value at the time of the dividend payment (to the extent not allowable as a deduction in computing net income for any taxable year) shall be treated as a dividend paid in the taxable year in which the redemption occurs.*

(e) TAXABLE STOCK DIVIDENDS.—*In case of a stock dividend or stock right which is a taxable dividend in the hands of shareholders under section 115 (f), the dividends paid credit with respect thereto shall be the fair market value of the stock or the stock right at the time of the payment.*

(f) DISTRIBUTIONS IN LIQUIDATION.—*In the case of amounts distributed in liquidation the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, shall, for the purposes of computing the dividends paid credit under this section, be treated as a taxable dividend paid.*

(g) PREFERENTIAL DIVIDENDS.—*No dividends paid credit shall be allowed with respect to any distribution unless the distribution is pro rata, equal in amount, and with no preference to any share of stock as compared with other shares of the same class.*

(h) NONTAXABLE DISTRIBUTIONS.—*If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, no dividends paid credit shall be allowed with respect to such part.*

Sec. 102. SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.

(a) IMPOSITION OF TAX.—There shall be levied, collected, and paid for each taxable year *(in addition to other taxes imposed by this title)* upon the net income of every corporation (other than a personal holding company as defined in section 351) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting *earnings or* profits to accumulate instead of being divided or distributed—

(1) In the case of corporations not subject to the surtax on undistributed profits imposed by section 14, a surtax equal to the sum of the following:

25 per centum of the amount of the retained net income not in excess of $100,000, plus

35 per centum of the amount of the retained net income in excess of $100,000.

(2) In the case of corporations subject to the surtax on undistributed profits imposed by section 14, a surtax equal to the sum of the following:

15 per centum of the amount of the retained net income not in excess of $100,000, plus

25 per centum of the amount of the retained net income in excess of $100,000.

(b) PRIMA FACIE EVIDENCE.—The fact that any corporation is a mere holding or investment company, or that the *earnings* or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to avoid surtax *upon shareholders.*

(c) DEFINITIONS.—*As used in this title—*

(1) SPEC'AL ADJUSTED NET INCOME.—*The term "special adjusted net income" means the net income minus the sum of—*

(A) Taxes.—Federal income, war-profits, and excess-profits taxes paid or accrued during the taxable year, to the extent not allowed as a deduction by section 23, but not including the tax imposed by this section or a corresponding section of a prior income-tax law.

(B) Disallowed charitable, etc., contributions.—Contributions or gifts, not otherwise allowed as a deduction, to or for the use of donees described in section 23 (o), for the purposes therein specified.

(C) Disallowed losses.—Losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117 (d).

(D) Bank affiliates.—In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933), the amount allowed as a credit under section 26 (d).

(E) National Mortgage Associations.—In the case of a national mortgage association created under Title III of the National Housing Act, the amount allowed as a credit under section 26 (e).

(2) RETAINED NET INCOME.—*The term "retained net income" means the special adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends. For the purposes of this subsection, such credits shall be computed by substituting in section 26 (c) and in section 27 for the words "adjusted net income" wherever appearing in such sections the words "special adjusted net income."*

(d) PAYMENT OF SURTAX ON PRO RATA SHARES.—The tax imposed by this section shall not apply if *(1)* all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed, or not, of the *retained* net income of the corporation for such year, *and (2) 90 per centum or more of such retained net income is so included in the gross income of shareholders other than corporations.* Any amount so included in the gross income of a shareholder shall be treated as a

dividend received. Any subsequent distribution made by the corporation out of earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his pro rata share, be exempt from tax in the amount of the share so included.

(e) TAX ON PERSONAL HOLDING COMPANIES.—For surtax on personal holding companies, see section 351.

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) DEFINITION OF DIVIDEND.—The term "dividend" when used in this title (except in section 203(a)*(3)* and section 207(c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, *(1)* out of its earnings or profits accumulated after February 28, 1913, *or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.*

(b) SOURCE OF DISTRIBUTIONS.—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

(c) DISTRIBUTIONS IN LIQUIDATION.—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. Despite the provisions of section 117 (a), 100 per centum of the gain so recognized shall

be taken into account in computing net income, *except in the case of amounts distributed in complete liquidation of a corporation. For the purpose of the preceding sentence, "complete liquidation" includes any one of a series of distributions made by a corporation in complete cancellation or redemption of all of its stock in accordance with a bona fide plan of liquidation and under which the transfer of the property under the liquidation is to be completed within a time specified in the plan, not exceeding two years from the close of the taxable year during which is made the first of the series of distributions under the plan.* In the case of amounts distributed (whether before January 1, 1934, or on or after such date) in partial liquidation (other than a distribution within the provisions of subsection (h) of this section of stock or securities in connection with a reorganization) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits.

(d) OTHER DISTRIBUTIONS FROM CAPITAL.—If any distribution (not in partial or complete liquidation) made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not *a dividend*, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property.

(e) DISTRIBUTIONS BY PERSONAL SERVICE CORPORATIONS.—Any distribution made by a corporation, which was classified as a personal service corporation under the provisions of the Revenue Act of 1918 or the Revenue Act of 1921, out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 or section 218 of the Revenue Act of 1921, shall be exempt from tax to the distributees.

(f) STOCK DIVIDENDS.—

(1) GENERAL RULE.—*A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder*

within the meaning of the Sixteenth Amendment to the Constitution.

(2) ELECTION OF SHAREHOLDERS AS TO MEDIUM OF PAYMENT.—*Whenever a distribution by a corporation is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either (A) in its stock or in rights to acquire its stock, of a class which if distributed without election would be exempt from tax under paragraph (1), or (B) in money or any other property (including its stock or in rights to acquire its stock, of a class which if distributed without election would not be exempt from tax under paragraph (1)), then the distribution shall constitute a taxable dividend in the hands of all shareholders, regardless of the medium in which paid.*

(g) REDEMPTION OF STOCK.—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

(h) EFFECT ON EARNINGS AND PROFITS OF DISTRIBUTIONS OF STOCK.—*The distribution (whether before January 1, 1936, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities or stock or securities in another corporation shall not be considered a distribution of earnings or profits of any corporation—*

(1) if no gain to such distributee from the receipt of such stock or securities was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

(i) DEFINITION OF PARTIAL LIQUIDATION.—As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

(j) VALUATION OF DIVIDEND.—*If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder.*

Sec. 117. CAPITAL GAINS AND LOSSES.

(a) GENERAL RULE.—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 1 year;

80 per centum if the capital asset has been held for more than 1 year but not for more than 2 years;

60 per centum if the capital asset has been held for more than 2 years but not for more than 5 years;

40 per centum if the capital asset has been held for more than 5 years but not for more than 10 years;

30 per centum if the capital asset has been held for more than 10 years.

(b) DEFINITION OF CAPITAL ASSETS.—For the purposes of this title, "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(c) DETERMINATION OF PERIOD FOR WHICH HELD.—For the purpose of subsection (a)—

(1) In determining the period for which the taxpayer has held property received on an exchange there shall

be included the period for which he held the property exchanged, if under the provisions of section 113, the property received has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged.

(2) In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, if under the provisions of section 113, such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

(3) In determining the period for which the taxpayer has held stock or securities received upon a distribution where no gain was recognized to the distributee under the provisions of section 112(g) of the Revenue Act of 1928 or the Revenue Act of 1932, there shall be included the period for which he held the stock or securities in the distributing corporation prior to the receipt of the stock or securities upon such distribution.

(4) In determining the period for which the taxpayer has held stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeductibility (under section 118 of this Act or section 118 of the Revenue Act of 1928 or the Revenue Act of 1932 *or the Revenue Act of 1934*, relating to wash sales) of the loss from the sale or other disposition of substantially identical stock or securities, there shall be included the period for which he held the stock or securities the loss from the sale or other disposition of which was not deductible.

(d) LIMITATION ON CAPITAL LOSSES.—Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges. If a bank or trust company incorporated under the laws of the United States or of any State or Territory, a substantial part of whose business is the receipt of deposits, sells any bond, debenture, note, or certificate or other evidence of indebtedness issued by any corporation (including one issued by a government or poli-

tical subdivision thereof), with interest coupons or in registered form, any loss resulting from such sale (except such portion of the loss as does not exceed the amount, if any, by which the adjusted basis of such instrument exceeds the par or face value thereof) shall not be subject to the foregoing limitation and shall not be included in determining the applicability of such limitation to other losses.

(e) GAINS AND LOSSES FROM SHORT SALES, ETC.—For the purpose of this title—

(1) gains or losses from short sales of property shall be considered as gains or losses from sales or exchanges of capital assets; and

(2) gains or losses attributable to the failure to exercise privileges or options to buy or sell property shall be considered as gains or losses from sales or exchanges of capital assets held for one year or less.

(f) RETIREMENT OF BONDS, ETC.—For the purposes of this title, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

Sec. 351. SURTAX ON PERSONAL HOLDING COMPANIES.

(a) IMPOSITION OF TAX.—There shall be levied, collected, and paid, for each taxable year *(in addition to the taxes imposed by Title I)*, upon the undistributed adjusted net income of every personal holding company a surtax equal to the sum of the following:

(1) *8* per centum of the amount thereof not in excess of $2,000; plus

(2) *18* per centum of the amount thereof in excess of $2,000 and not in excess of $100,000; plus

(3) *28* per centum of the amount thereof in excess of $100,000 and not in excess of $500,000; plus

(4) *38* per centum of the amount thereof in excess of $500,000 and not in excess of $1,000,000; plus

(5) *48* per centum of the amount thereof in excess of $1,000,000.

(b) DEFINITIONS.—As used in this title—

(1) The term "personal holding company" means any corporations (other than a corporation exempt from taxation under section 101, and other than a bank, *as defined in section 104,* and other than a life-insurance company or surety company) *if*—(A) at least 80 per centum of its gross income for the taxable year is derived from royalties, dividends, interest, annuities, and (except in the case of regular dealers in stock or securities) gains from the sale of stock or securities, and (B) at any time during the last half of the taxable year more than 50 per centum in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals. For the purpose of determining the ownership of stock in a personal holding company—(C) stock owned, directly or indirectly, by a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries; (D) an individual shall be considered as owning, to the exclusion of any other individual, the stock owned, directly or indirectly, by his family, and this rule shall be applied in such manner as to produce the smallest possible number of individuals owning, directly or indirectly, more than 50 per centum in value of the outstanding stock; and (E) the family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

(2) The term "undistributed adjusted net income" means the adjusted net income minus the sum of:

(A) 20 per centum of the excess of the adjusted net income over the amount of dividends received from personal holding companies which are allowable as a *credit* for the purposes of the tax imposed by section 13 or 204;

(B) Amounts used or set aside to retire indebtedness incurred prior to January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness; and

(C) The amount of the dividends paid credit provided in section 27, computed without the benefit of subsection (b) thereof (relating to the dividend carry-over).

(3) The term "adjusted net income" means the net income minus the sum of:

(A) Federal income, war-profits, and excess-profits taxes paid or accrued *during the taxable year to the extent not allowed as a deduction by section 23,* but not including the tax imposed by this section *or a corresponding section of a prior income-tax law;*

(B) Contributions or gifts, not otherwise allowed as a deduction, to or for the use of donees described in section 23(o) for the purposes therein specified, *including, in the case of a corporation organized prior to January 1, 1936, to take over the assets and liabilities of the estate of a decedent, amounts paid in liquidation of any liability of the corporation based on the liability of the decedent to make any such contribution or gift, to the extent such liability of the decedent existed prior to January 1, 1934;* and

(C) Losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117 (d).

(4) The terms used in this section shall have the same meaning as when used in Title I.

(c) ADMINISTRATIVE PROVISIONS.—All provisions of law (including penalties) applicable in respect of the taxes imposed by Title 1 of this Act, shall insofar as not inconsistent with this section, be applicable in respect of the tax imposed by this section, except that the provisions of section 131 of that title shall not be applicable.

(d) PAYMENT OF SURTAX ON PRO RATA SHARES.—The tax imposed by this section shall not apply if *(1)* all the share-

holders of the corporation include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the adjusted net income of the corporation for such year, *and (2) 90 per centum or more of such adjusted net income is so included in the gross income of shareholders other than corporations.* Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his pro rata share, be exempt from tax in the amount of the share so included.

(e) IMPROPER ACCUMULATIONS OF SURPLUS.—For surtax on corporations which accumulate surplus to avoid surtax on stockholders, see section 102.